Minutes of Federal Open Market Committee Meetings

The policy actions of the Federal Open Market Committee, contained in the minutes of its meetings, are presented in the ANNUAL REPORT of the Board of Governors pursuant to the requirements of section 10 of the Federal Reserve Act. That section provides that the Board shall keep a complete record of the actions taken by the Board and by the Federal Open Market Committee on all questions of policy relating to open market operations, that it shall record therein the votes taken in connection with the determination of open market policies and the reasons underlying each such action, and that it shall include in its annual report to the Congress a full account of such actions.

The minutes of the meetings contain the votes on the policy decisions made at those meetings as well as a résumé of the discussions that led to the decisions. The summary descriptions of economic and financial conditions are based on the information that was available to the Committee at the time of the meetings rather than on data as they may have been revised later.

Members of the Committee voting for a particular action may differ among themselves as to the reasons for their votes; in such cases, the range of their views is noted in the minutes. When members dissent from a decision, they are identified in the minutes along with a summary of the reasons for their dissent.

Policy directives of the Federal Open Market Committee are issued to the Federal Reserve Bank of New York as the Bank selected by the Committee to execute transactions for the System Open Market Account. In the area of domestic open market activities, the Federal Reserve Bank of New York operates under two sets of instructions from the Federal Open Market Committee: an Authorization for Domestic Open Market Operations and a Domestic Policy Directive. (A new Domestic Policy Directive is adopted at each regularly scheduled meeting.) In the foreign currency area, the Committee operates under an Authorization for Foreign Currency Operations, a Foreign Currency Directive, and Procedural Instructions with Respect to Foreign Currency Operations. These policy instruments are shown below in the form in which they were in effect at the beginning of 1997. Changes in the instruments during the year are reported in the minutes for the individual meetings.

Authorization for Domestic Open Market Operations

In Effect January 1, 1997

1. The Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York, to the extent necessary to carry out the most recent domestic policy directive adopted at a meeting of the Committee:

(a) To buy or sell U.S. Government securities, including securities of the Federal Financing Bank, and securities that are direct obligations of, or fully guaranteed as to principal and interest by, any agency of the United States in the open market, from or to securities dealers and foreign and international accounts maintained at the Federal

Reserve Bank of New York, on a cash, regular, or deferred delivery basis, for the System Open Market Account at market prices, and, for such Account, to exchange maturing U.S. Government and Federal agency securities with the Treasury or the individual agencies or to allow them to mature without replacement; provided that the aggregate amount of U.S. Government and Federal agency securities held in such Account (including forward commitments) at the close of business on the day of a meeting of the Committee at which action is taken with respect to a domestic policy directive shall not be increased or decreased by more than $8.0 billion during the period commencing with the opening of business on the day following such meeting and ending with the close of business on the day of the next such meeting;

(b) When appropriate, to buy or sell in the open market, from or to acceptance dealers and foreign accounts maintained at the Federal Reserve Bank of New York, on a cash, regular, or deferred delivery basis, for the account of the Federal Reserve Bank of New York at market discount rates, prime bankers acceptances with maturities of up to nine months at the time of acceptance that (1) arise out of the current shipment of goods between countries or within the United States, or (2) arise out of the storage within the United States of goods under contract of sale or expected to move into the channels of trade within a reasonable time and that are secured throughout their life by a warehouse receipt or similar document conveying title to the underlying goods; provided that the aggregate amount of bankers acceptances held at any one time shall not exceed $100 million;

(c) To buy U.S. Government securities, obligations that are direct obligations of, or fully guaranteed as to principal and interest by, any agency of the United States, and prime bankers acceptances of the types authorized for purchase under 1(b) above, from dealers for the account of the Federal Reserve Bank of New York under agreements for repurchase of such securities, obligations, or acceptances in 15 calendar days or less, at rates that, unless otherwise expressly authorized by the Committee, shall be determined by competitive bidding, after applying reasonable limitations on the volume of agreements with individual dealers; provided that in the event Government securities or agency issues covered by any such agreement are not repurchased by the dealer pursuant to the agreement or a renewal thereof, they shall be sold in the market or transferred to the System Open Market Account; and provided further that in the event bankers acceptances covered by any such agreement are not repurchased by the seller, they shall continue to be held by the Federal Reserve Bank or shall be sold in the open market.

2. In order to ensure the effective conduct of open market operations, the Federal Open Market Committee authorizes and directs the Federal Reserve Banks to lend U.S. Government securities held in the System Open Market Account to Government securities dealers and to banks participating in Government securities clearing arrangements conducted through a Federal Reserve Bank, under such instructions as the Committee may specify from time to time.

3. In order to ensure the effective conduct of open market operations, while assisting in the provision of short-term investments for foreign and international accounts maintained at the Federal Reserve Bank of New York, the Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York (a) for System Open Market Account, to sell U.S. Government securities to such foreign and international accounts on the bases set forth in paragraph 1(a) under agreements providing for the resale by such accounts of those securities within 15 calendar days on terms comparable to those available on such transactions in the market; and (b) for New York Bank account, when appropriate, to undertake with dealers, subject to the conditions imposed on purchases and sales of securities in paragraph 1(c), repurchase agreements in U.S. Government and agency securities, and to arrange corresponding sale and repurchase agreements between its own account and foreign and international accounts maintained at the Bank. Transactions undertaken with such accounts under the provisions of this paragraph may provide for a service fee when appropriate.

Domestic Policy Directive

In Effect January 1, 1997[1]

The information reviewed at this meeting suggests that economic activity has continued to expand at a moderate pace. Private nonfarm payroll employment increased appreciably further in November, although the civilian unemployment rate edged up to 5.4 percent. Industrial production rose sharply in November, in part because of a rebound in motor vehicle assemblies that had been depressed earlier by work stoppages. Consumer spending has posted appreciable gains over recent months after a summer lull. Housing starts rebounded in November after declining in September and October. Business fixed investment appears to be growing moderately after a sharp rise in the third quarter. The nominal deficit on U.S. trade in goods and services widened substantially in the third quarter from its rate in the second quarter. Increases in labor compensation have trended up this year, and consumer price inflation also has picked up owing to larger increases in food and energy prices.

Short-term market interest rates have registered mixed changes since the Committee meeting on November 13, 1996, while long-term yields have risen slightly. In foreign exchange markets, the trade-weighted value of the dollar in terms of the other G-10 currencies has risen slightly over the intermeeting period.

Growth of M2 picked up in November, while expansion of M3 moderated somewhat from its brisk pace in October. For the year through November, M2 is estimated to have grown at a rate in the upper half of the Committee's annual range, and M3 at a rate a little above the top of its range. Total domestic nonfinancial debt has expanded moderately on balance over recent months and has remained in the middle portion of its range.

The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. In furtherance of these objectives, the Committee at its meeting in July reaffirmed the ranges it had established in January for growth of M2 and M3 of 1 to 5 percent and 2 to 6 percent respectively, measured from the fourth quarter of 1995 to the fourth quarter of 1996. The monitoring range for growth of total domestic nonfinancial debt was maintained at 3 to 7 percent for the year. For 1997, the Committee agreed on a tentative basis to set the same ranges as in 1996 for growth of the monetary aggregates and debt, measured from the fourth quarter of 1996 to the fourth quarter of 1997. The behavior of the monetary aggregates will continue to be evaluated in the light of progress toward price level stability, movements in their velocities, and developments in the economy and financial markets.

In the implementation of policy for the immediate future, the Committee seeks to maintain the existing degree of pressure on reserve positions. In the context of the Committee's long-run objectives for price stability and sustainable economic growth, and giving careful consideration to economic, financial, and monetary developments, somewhat greater reserve restraint would or slightly lesser reserve restraint might be acceptable in the intermeeting period. The contemplated reserve conditions are expected to be consistent with relatively strong expansion in M2 and M3 over coming months.

1. Adopted by the Committee at its meeting on December 17, 1996.

Authorization for Foreign Currency Operations

In Effect January 1, 1997

1. The Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York, for System Open Market Account, to the extent necessary to carry out the Committee's foreign currency directive and express authorizations by the Committee pursuant thereto, and in conformity with such procedural instructions as the Committee may issue from time to time:

A. To purchase and sell the following foreign currencies in the form of cable transfers through spot or forward transactions on the open market at home and abroad, including transactions with the U.S. Treasury, with the U.S. Exchange Stabilization Fund established by Section 10 of the Gold Reserve Act of 1934, with foreign monetary authorities, with the Bank for International Settlements, and with other international financial institutions:

Austrian schillings	Italian lire
Belgian francs	Japanese yen
Canadian dollars	Mexican pesos
Danish kroner	Netherlands guilders
Pounds sterling	Norwegian kroner
French francs	Swedish kronor
German marks	Swiss francs

B. To hold balances of, and to have outstanding forward contracts to receive or to deliver, the foreign currencies listed in paragraph A above.

C. To draw foreign currencies and to permit foreign banks to draw dollars under the reciprocal currency arrangements listed in paragraph 2 below, provided that drawings by either party to any such arrangement shall be fully liquidated within 12 months after any amount outstanding at that time was first drawn, unless the Committee, because of exceptional circumstances, specifically authorizes a delay.

D. To maintain an overall open position in all foreign currencies not exceeding $25.0 billion. For this purpose, the overall open position in all foreign currencies is defined as the sum (disregarding signs) of net positions in individual currencies. The net position in a single foreign currency is defined as holdings of balances in that currency, plus outstanding contracts for future receipt, minus outstanding contracts for future delivery of that currency, i.e., as the sum of these elements with due regard to sign.

2. The Federal Open Market Committee directs the Federal Reserve Bank of New York to maintain reciprocal currency arrangements (“swap” arrangements) for the System Open Market Account for periods up to a maximum of 12 months with the following foreign banks, which are among those designated by the Board of Governors of the Federal Reserve System under Section 214.5 of Regulation N, Relations with Foreign Banks and Bankers, and with the approval of the Committee to renew such arrangements on maturity:

Foreign bank	Amount (millions of dollars equivalent)
Austrian National Bank	250
National Bank of Belgium	1,000
Bank of Canada	2,000
National Bank of Denmark	250
Bank of England	3,000
Bank of France	2,000
German Federal Bank	6,000
Bank of Italy	3,000
Bank of Japan	5,000
Bank of Mexico	3,000
Netherlands Bank	500
Bank of Norway	250
Bank of Sweden	300
Swiss National Bank	4,000
Bank for International Settlements	
Dollars against Swiss francs	600
Dollars against authorized European currencies other than Swiss francs	1,250

Any changes in the terms of existing swap arrangements, and the proposed terms of any new arrangements that may be authorized, shall be referred for review and approval to the Committee.

3. All transactions in foreign currencies undertaken under paragraph 1(A) above shall, unless otherwise expressly authorized by the Committee, be at prevailing market rates. For the purpose of providing an investment return on System holdings of foreign currencies, or for the purpose of adjusting interest rates paid or received in connection with swap drawings, transactions with foreign central banks may be undertaken at non-market exchange rates.

4. It shall be the normal practice to arrange with foreign central banks for the coordination of foreign currency transactions. In making operating arrangements with foreign central banks on System holdings of foreign currencies, the Federal Reserve Bank of New York shall not commit itself to maintain any specific balance, unless authorized by the Federal Open Market Committee. Any agreements or understandings concerning the administration of the accounts maintained by the Federal Reserve Bank of New York with the foreign banks designated by the Board of Governors under Section 214.5 of Regulation N shall be referred for review and approval to the Committee.

5. Foreign currency holdings shall be invested to ensure that adequate liquidity is maintained to meet anticipated needs and so that each currency portfolio shall generally have an average duration of no more than 18 months (calculated as Macaulay duration). When appropriate in connection with arrangements to provide investment facilities for foreign currency holdings, U.S. Government securities may be purchased from foreign central banks under agreements for repurchase of such securities within 30 calendar days.

6. All operations undertaken pursuant to the preceding paragraphs shall be reported promptly to the Foreign Currency Subcommittee and the Committee. The Foreign Currency Subcommittee consists of the Chairman and Vice Chairman of the Committee, the Vice Chairman of the Board of Governors, and such other member of the Board as the Chairman may designate (or in the absence of members of the Board serving on the Subcommittee, other Board Members designated by the Chairman as alternates, and in the absence of the Vice Chairman of the Committee, his alternate). Meetings of the Subcommittee shall be called at the request of any member, or at the request of the Manager, System Open Market Account (“Manager”), for the purposes of reviewing recent or contemplated operations and of consulting with the Manager on other matters relating to his responsibilities. At the request of any member of the Subcommittee, questions arising from such reviews and consultations shall be referred for determination to the Federal Open Market Committee.

7. The Chairman is authorized:

A. With the approval of the Committee, to enter into any needed agreement or understanding with the Secretary of the Treasury about the division of responsibility for foreign currency operations between the System and the Treasury;

B. To keep the Secretary of the Treasury fully advised concerning System foreign currency operations, and to consult with the Secretary on policy matters relating to foreign currency operations;

C. From time to time, to transmit appropriate reports and information to the National Advisory Council on International Monetary and Financial Policies.

8. Staff officers of the Committee are authorized to transmit pertinent information on System foreign currency operations to appropriate officials of the Treasury Department.

9. All Federal Reserve Banks shall participate in the foreign currency operations for System Account in accordance with paragraph 3 G(1) of the Board of Governors’ Statement of Procedure with Respect to Foreign Relationships of Federal Reserve Banks dated January 1, 1944.

Foreign Currency Directive

In Effect January 1, 1997

1. System operations in foreign currencies shall generally be directed at countering disorderly market conditions, provided that market exchange rates for the U.S. dollar reflect actions and behavior consistent with the IMF Article IV, Section 1.

2. To achieve this end the System shall:

A. Undertake spot and forward purchases and sales of foreign exchange.

B. Maintain reciprocal currency (“swap”) arrangements with selected foreign central banks and with the Bank for International Settlements.

C. Cooperate in other respects with central banks of other countries and with international monetary institutions.

3. Transactions may also be undertaken:

A. To adjust System balances in light of probable future needs for currencies.

B. To provide means for meeting System and Treasury commitments in particular currencies, and to facilitate operations of the Exchange Stabilization Fund.

C. For such other purposes as may be expressly authorized by the Committee.

4. System foreign currency operations shall be conducted:

A. In close and continuous consultation and cooperation with the United States Treasury;

B. In cooperation, as appropriate, with foreign monetary authorities; and

C. In a manner consistent with the obligations of the United States in the International Monetary Fund regarding exchange arrangements under the IMF Article IV.

Procedural Instructions with Respect to Foreign Currency Operations

In Effect January 1, 1997

In conducting operations pursuant to the authorization and direction of the Federal Open Market Committee as set forth in the Authorization for Foreign Currency Operations and the Foreign Currency Directive, the Federal Reserve Bank of New York, through the Manager, System Open Market Account (“Manager”), shall be guided by the following procedural understandings with respect to consultations and clearance with the Committee, the Foreign Currency Subcommittee, and the Chairman of the Committee. All operations undertaken pursuant to such clearances shall be reported promptly to the Committee.

1. The Manager shall clear with the Subcommittee (or with the Chairman, if the Chairman believes that consultation with the Subcommittee is not feasible in the time available):

A. Any operation that would result in a change in the System’s overall open position in foreign currencies exceeding $300 million on any day or $600 million since the most recent regular meeting of the Committee.

B. Any operation that would result in a change on any day in the System’s net position in a single foreign currency exceeding $150 million, or $300 million when the operation is associated with repayment of swap drawings.

C. Any operation that might generate a substantial volume of trading in a particular currency by the System, even though the change in the System’s net position in that currency might be less than the limits specified in 1.B.

D. Any swap drawing proposed by a foreign bank not exceeding the larger of (i) $200 million or (ii) 15 percent of the size of the swap arrangement.

2. The Manager shall clear with the Committee (or with the Subcommittee, if the Subcommittee believes that consultation with the full Committee is not feasible in the time available, or with the Chairman, if the Chairman believes that consultation with the Subcommittee is not feasible in the time available):

A. Any operation that would result in a change in the System’s overall open position in foreign currencies exceeding $1.5 billion since the most recent regular meeting of the Committee.

B. Any swap drawing proposed by a foreign bank exceeding the larger of (i) $200 million or (ii) 15 percent of the size of the swap arrangement.

3. The Manager shall also consult with the Subcommittee or the Chairman about proposed swap drawings by the System, and about any operations that are not of a routine character.

Meeting Held on February 4–5, 1997

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Tuesday, February 4, 1997, at 2:30 p.m. and continued on Wednesday, February 5, 1997, at 9:00 a.m.

Present:

Mr. Greenspan, Chairman
Mr. McDonough, Vice Chairman
Mr. Broaddus
Mr. Guynn
Mr. Kelley
Mr. Meyer
Mr. Moskow
Mr. Parry
Ms. Phillips
Ms. Rivlin

Messrs. Hoenig, Jordan, Melzer, and Ms. Minehan, Alternate Members of the Federal Open Market Committee

Messrs. Boehne, McTeer, and Stern, Presidents of the Federal Reserve Banks of Philadelphia, Dallas, and Minneapolis respectively

Mr. Kohn, Secretary and Economist
Mr. Bernard, Deputy Secretary
Mr. Coyne, Assistant Secretary
Mr. Gillum, Assistant Secretary
Mr. Mattingly, General Counsel
Mr. Baxter, Deputy General Counsel [2]
Mr. Prell, Economist
Mr. Truman, Economist

Messrs. Beebe, Eisenbeis, Goodfriend, Hunter, Lindsey, Mishkin, Promisel, Siegman, Slifman, and Stockton, Associate Economists

Mr. Fisher, Manager, System Open Market Account

Mr. Ettin, Deputy Director, Division of Research and Statistics, Board of Governors
Mr. Winn, Assistant to the Board, Office of Board Members, Board of Governors
Messrs. Madigan and Simpson, Associate Directors, Divisions of Monetary Affairs and Research and Statistics respectively, Board of Governors
Ms. Johnson,[3] Assistant Director, Division of International Finance, Board of Governors
Messrs. Brady [3] and Reifschneider,[3] Section Chiefs, Divisions of Monetary Affairs and Research and Statistics respectively, Board of Governors
Messrs. Brayton [3] and Rosine,[3] Senior Economists, Division of Research and Statistics, Board of Governors
Ms. Garrett, Economist, Division of Monetary Affairs, Board of Governors
Ms. Low, Open Market Secretariat Assistant, Division of Monetary Affairs, Board of Governors
Ms. Browne, Messrs. Dewald, Hakkio, Lang, Rosenblum, and Sniderman, Senior Vice Presidents, Federal Reserve Banks of Boston, St. Louis, Kansas City, Philadelphia, Dallas, and Cleveland respectively
Mr. Miller and Ms. Perelmuter, Vice Presidents, Federal Reserve Banks of Minneapolis and New York respectively

In the agenda for this meeting, it was reported that advices of the election of the following members and alternate members of the Federal Open Market Committee for the period commencing January 1, 1997, and ending December 31, 1997, had been received and that the named individuals had executed their oaths of office.

The elected members and alternate members were as follows:

William J. McDonough, President of the Federal Reserve Bank of New York, with Ernest T. Patrikis, First Vice President of the Federal Reserve Bank of New York, as alternate;

2. Attended Tuesday session only.

3. Attended portions of meeting relating to the Committee's review of the economic outlook and establishment of its monetary and debt ranges for 1997.

J. Alfred Broaddus, Jr., President of the Federal Reserve Bank of Richmond, with Cathy E. Minehan, President of the Federal Reserve Bank of Boston, as alternate;
Michael H. Moskow, President of the Federal Reserve Bank of Chicago, with Jerry L. Jordan, President of the Federal Reserve Bank of Cleveland, as alternate;
Jack Guynn, President of the Federal Reserve Bank of Atlanta, with Thomas C. Melzer, President of the Federal Reserve Bank of St. Louis, as alternate;
Robert T. Parry, President of the Federal Reserve Bank of San Francisco, with Thomas M. Hoenig, President of the Federal Reserve Bank of Kansas City, as alternate.

By unanimous vote, the following officers of the Federal Open Market Committee were elected to serve until the election of their successors at the first meeting of the Committee after December 31, 1997, with the understanding that in the event of the discontinuance of their official connection with the Board of Governors or with a Federal Reserve Bank, they would cease to have any official connection with the Federal Open Market Committee:

Alan Greenspan	Chairman
William J. McDonough	Vice Chairman
Donald L. Kohn	Secretary and Economist
Normand R.V. Bernard	Deputy Secretary
Joseph R. Coyne	Assistant Secretary
Gary P. Gillum	Assistant Secretary
J. Virgil Mattingly, Jr.	General Counsel
Thomas C. Baxter, Jr.	Deputy General Counsel
Michael J. Prell	Economist
Edwin M. Truman	Economist

Jack H. Beebe, Robert A. Eisenbeis, Marvin S. Goodfriend, William C. Hunter, David E. Lindsey, Frederic S. Mishkin, Larry J. Promisel, Charles J. Siegman, Lawrence Slifman, and David J. Stockton, Associate Economists

By unanimous vote, the Federal Reserve Bank of New York was selected to execute transactions for the System Open Market Account until the adjournment of the first meeting of the Committee after December 31, 1997.

By unanimous vote, Peter R. Fisher was selected to serve at the pleasure of the Committee as Manager, System Open Market Account, on the understanding that his selection was subject to being satisfactory to the Federal Reserve Bank of New York.

Secretary's note: Advice subsequently was received that the selection of Mr. Fisher as Manager was satisfactory to the board of directors of the Federal Reserve Bank of New York.

By unanimous vote, the Authorization for Domestic Open Market Operations shown below was reaffirmed.

Authorization for Domestic Open Market Operations

1. The Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York, to the extent necessary to carry out the most recent domestic policy directive adopted at a meeting of the Committee:

(a) To buy or sell U.S. Government securities, including securities of the Federal Financing Bank, and securities that are direct obligations of, or fully guaranteed as to principal and interest by, any agency of the United States in the open market, from or to securities dealers and foreign and international accounts maintained at the Federal Reserve Bank of New York, on a cash, regular, or deferred delivery basis, for the System Open Market Account at market prices, and, for such Account, to exchange maturing U.S. Government and Federal agency securities with the Treasury or the individual agencies or to allow them to mature without replacement; provided that the aggregate amount of U.S. Government and Federal agency securities held in such Account (including forward commitments) at the close of business on the day of a meeting of the Committee at which action is taken with respect to a domestic policy directive shall not be increased or decreased by more than $8.0 billion during the period commencing with the opening of business on the day following such meeting and ending with the close of business on the day of the next such meeting;

(b) When appropriate, to buy or sell in the open market, from or to acceptance dealers and foreign accounts maintained at the Federal Reserve Bank of New York, on a cash, regular, or deferred delivery basis, for the account of the Federal Reserve Bank of New York at market discount rates, prime bankers acceptances with maturities of up to nine months at the time of acceptance that (1) arise out of the current shipment of goods between countries or within the United States, or (2) arise out of the storage within the United States of goods under contract of sale or expected to move into the channels of trade within a reasonable time and that are secured throughout their life by a warehouse receipt or similar document conveying title to the underlying goods; provided that the aggregate amount of bankers acceptances held at any one time shall not exceed $100 million;

(c) To buy U.S. Government securities, obligations that are direct obligations of, or fully guaranteed as to principal and interest by, any agency of the United States, and prime bankers acceptances of the types authorized for purchase under l(b) above, from dealers for the account of the Federal Reserve Bank of New York under agreements for repurchase of such securities, obligations, or acceptances in 15 calendar days or less, at rates that, unless otherwise expressly authorized by the Committee, shall be determined by competitive bidding, after applying reasonable limitations on the volume of agreements with individual dealers; provided that in the event Government securities or agency issues covered by any such agreement are not repurchased by the dealer pursuant to the agreement or a renewal thereof, they shall be sold in the market or transferred to the System Open Market Account; and provided further that in the event bankers acceptances covered by any such agreement are not repurchased by the seller, they shall continue to be held by the Federal Reserve Bank or shall be sold in the open market.

2. In order to ensure the effective conduct of open market operations, the Federal Open Market Committee authorizes and directs the Federal Reserve Banks to lend U.S. Government securities held in the System Open Market Account to Government securities dealers and to banks participating in Government securities clearing arrangements conducted through a Federal Reserve Bank, under such instructions as the Committee may specify from time to time.

3. In order to ensure the effective conduct of open market operations, while assisting in the provision of short-term investments for foreign and international accounts maintained at the Federal Reserve Bank of New York, the Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York (a) for System Open Market Account, to sell U.S. Government securities to such foreign and international accounts on the bases set forth in paragraph l(a) under agreements providing for the resale by such accounts of those securities within 15 calendar days on terms comparable to those available on such transactions in the market; and (b) for New York Bank account, when appropriate, to undertake with dealers, subject to the conditions imposed on purchases and sales of securities in paragraph l(c), repurchase agreements in U.S. Government and agency securities, and to arrange corresponding sale and repurchase agreements between its own account and foreign and international accounts maintained at the Bank. Transactions undertaken with such accounts under the provisions of this paragraph may provide for a service fee when appropriate.

With Mr. Broaddus dissenting, the Authorization for Foreign Currency Operations shown below was reaffirmed.

Authorization for Foreign Currency Operations

1. The Federal Open Market Committee authorizes and directs the Federal Reserve Bank of New York, for System Open Market

Account, to the extent necessary to carry out the Committee's foreign currency directive and express authorizations by the Committee pursuant thereto, and in conformity with such procedural instructions as the Committee may issue from time to time:

A. To purchase and sell the following foreign currencies in the form of cable transfers through spot or forward transactions on the open market at home and abroad, including transactions with the U.S. Treasury, with the U.S. Exchange Stabilization Fund established by Section 10 of the Gold Reserve Act of 1934, with foreign monetary authorities, with the Bank for International Settlements, and with other international financial institutions:

Austrian schillings	Italian lire
Belgian francs	Japanese yen
Canadian dollars	Mexican pesos
Danish kroner	Netherlands guilders
Pounds sterling	Norwegian kroner
French francs	Swedish kronor
German marks	Swiss francs

B. To hold balances of, and to have outstanding forward contracts to receive or to deliver, the foreign currencies listed in paragraph A above.

C. To draw foreign currencies and to permit foreign banks to draw dollars under the reciprocal currency arrangements listed in paragraph 2 below, provided that drawings by either party to any such arrangement shall be fully liquidated within 12 months after any amount outstanding at that time was first drawn, unless the Committee, because of exceptional circumstances, specifically authorizes a delay.

D. To maintain an overall open position in all foreign currencies not exceeding $25.0 billion. For this purpose, the overall open position in all foreign currencies is defined as the sum (disregarding signs) of net positions in individual currencies. The net position in a single foreign currency is defined as holdings of balances in that currency, plus outstanding contracts for future receipt, minus outstanding contracts for future delivery of that currency, i.e., as the sum of these elements with due regard to sign.

2. The Federal Open Market Committee directs the Federal Reserve Bank of New York to maintain reciprocal currency arrangements ("swap" arrangements) for the System Open Market Account for periods up to a maximum of 12 months with the following foreign banks, which are among those designated by the Board of Governors of the Federal Reserve System under Section 214.5 of Regulation N, Relations with Foreign Banks and Bankers, and with the approval of the Committee to renew such arrangements on maturity:

Foreign bank	Amount (millions of dollars equivalent)
Austrian National Bank	250
National Bank of Belgium	1,000
Bank of Canada	2,000
National Bank of Denmark	250
Bank of England	3,000
Bank of France	2,000
German Federal Bank	6,000
Bank of Italy	3,000
Bank of Japan	5,000
Bank of Mexico	3,000
Netherlands Bank	500
Bank of Norway	250
Bank of Sweden	300
Swiss National Bank	4,000
Bank for International Settlements	
Dollars against Swiss francs	600
Dollars against authorized European currencies other than Swiss francs	1,250

Any changes in the terms of existing swap arrangements, and the proposed terms of any new arrangements that may be authorized, shall be referred for review and approval to the Committee.

3. All transactions in foreign currencies undertaken under paragraph 1.A. above shall, unless otherwise expressly authorized by the Committee, be at prevailing market rates. For the purpose of providing an investment return on System holdings of foreign currencies, or for the purpose of adjusting interest rates paid or received in connection with swap drawings, transactions with foreign central banks may be undertaken at non-market exchange rates.

4. It shall be the normal practice to arrange with foreign central banks for the coordination of foreign currency transactions. In making operating arrangements with foreign central banks on System holdings of foreign currencies, the Federal Reserve Bank of New York shall not commit itself to maintain any specific balance, unless authorized by the Federal Open Market Committee. Any agreements or understandings concerning the administration of the accounts maintained by the Federal Reserve Bank of New York with the foreign banks

designated by the Board of Governors under Section 214.5 of Regulation N shall be referred for review and approval to the Committee.

5. Foreign currency holdings shall be invested to ensure that adequate liquidity is maintained to meet anticipated needs and so that each currency portfolio shall generally have an average duration of no more than 18 months (calculated as Macaulay duration). When appropriate in connection with arrangements to provide investment facilities for foreign currency holdings, U.S. Government securities may be purchased from foreign central banks under agreements for repurchase of such securities within 30 calendar days.

6. All operations undertaken pursuant to the preceding paragraphs shall be reported promptly to the Foreign Currency Subcommittee and the Committee. The Foreign Currency Subcommittee consists of the Chairman and Vice Chairman of the Committee, the Vice Chairman of the Board of Governors, and such other member of the Board as the Chairman may designate (or in the absence of members of the Board serving on the Subcommittee, other Board members designated by the Chairman as alternates, and in the absence of the Vice Chairman of the Committee, his alternate). Meetings of the Subcommittee shall be called at the request of any member, or at the request of the Manager, System Open Market Account (“Manager”), for the purposes of reviewing recent or contemplated operations and of consulting with the Manager on other matters relating to his responsibilities. At the request of any member of the Subcommittee, questions arising from such reviews and consultations shall be referred for determination to the Federal Open Market Committee.

7. The Chairman is authorized:

A. With the approval of the Committee, to enter into any needed agreement or understanding with the Secretary of the Treasury about the division of responsibility for foreign currency operations between the System and the U.S. Treasury;

B. To keep the Secretary of the Treasury fully advised concerning System foreign currency operations, and to consult with the Secretary on policy matters relating to foreign currency operations;

C. From time to time, to transmit appropriate reports and information to the National Advisory Council on International Monetary and Financial Policies.

8. Staff officers of the Committee are authorized to transmit pertinent information on System foreign currency operations to appropriate officials of the U.S. Treasury Department.

9. All Federal Reserve Banks shall participate in the foreign currency operations for System Account in accordance with paragraph 3 G(1) of the Board of Governors' Statement of Procedure with Respect to Foreign Relationships of Federal Reserve Banks dated January 1, 1944.

With Mr. Broaddus dissenting, the Foreign Currency Directive shown below was reaffirmed.

Foreign Currency Directive

1. System operations in foreign currencies shall generally be directed at countering disorderly market conditions, provided that market exchange rates for the U.S. dollar reflect actions and behavior consistent with the IMF Article IV, Section 1.

2. To achieve this end the System shall:

A. Undertake spot and forward purchases and sales of foreign exchange.

B. Maintain reciprocal currency (“swap”) arrangements with selected foreign central banks and with the Bank for International Settlements.

C. Cooperate in other respects with central banks of other countries and with international monetary institutions.

3. Transactions may also be undertaken:

A. To adjust System balances in light of probable future needs for currencies.

B. To provide means for meeting System and U.S. Treasury commitments in particular currencies, and to facilitate operations of the Exchange Stabilization Fund.

C. For such other purposes as may be expressly authorized by the Committee.

4. System foreign currency operations shall be conducted:

A. In close and continuous consultation and cooperation with the U.S. Treasury;

B. In cooperation, as appropriate, with foreign monetary authorities; and

C. In a manner consistent with the obligations of the United States in the International Monetary Fund regarding exchange arrangements under the IMF Article IV.

Mr. Broaddus dissented in the votes on the Authorization and the Directive because they provide the foundation for foreign exchange market intervention. He believed that the Federal Reserve's participation in foreign exchange market intervention compromises its ability to conduct monetary policy effectively. Because sterilized intervention cannot have sustained effects in the absence of conforming monetary policy actions, Federal Reserve participation in foreign exchange operations in his view risks one of two undesirable outcomes. First, the independence of monetary policy is jeopardized if the System adjusts its policy actions to support short-term foreign exchange objectives set by the U.S. Treasury. Alternatively, the credibility of monetary policy is damaged if the System does not follow interventions with compatible policy actions, the interventions consequently fail to achieve their objectives, and the System is associated in the mind of the public with the failed operations.

By unanimous vote, the Procedural Instructions with Respect to Foreign Currency Operations shown below were reaffirmed.

Procedural Instructions with Respect to Foreign Currency Operations

In conducting operations pursuant to the authorization and direction of the Federal Open Market Committee as set forth in the Authorization for Foreign Currency Operations and the Foreign Currency Directive, the Federal Reserve Bank of New York, through the Manager, System Open Market Account (''Manager''), shall be guided by the following procedural understandings with respect to consultations and clearances with the Committee, the Foreign Currency Subcommittee, and the Chairman of the Committee. All operations undertaken pursuant to such clearances shall be reported promptly to the Committee.

1. The Manager shall clear with the Subcommittee (or with the Chairman, if the Chairman believes that consultation with the Subcommittee is not feasible in the time available):

   A. Any operation that would result in a change in the System's overall open position in foreign currencies exceeding $300 million on any day or $600 million since the most recent regular meeting of the Committee.

   B. Any operation that would result in a change on any day in the System's net position in a single foreign currency exceeding $150 million, or $300 million when the operation is associated with repayment of swap drawings.

   C. Any operation that might generate a substantial volume of trading in a particular currency by the System, even though the change in the System's net position in that currency might be less than the limits specified in 1.B.

   D. Any swap drawing proposed by a foreign bank not exceeding the larger of (i) $200 million or (ii) 15 percent of the size of the swap arrangement.

2. The Manager shall clear with the Committee (or with the Subcommittee, if the Subcommittee believes that consultation with the full Committee is not feasible in the time available, or with the Chairman, if the Chairman believes that consultation with the Subcommittee is not feasible in the time available):

   A. Any operation that would result in a change in the System's overall open position in foreign currencies exceeding $1.5 billion since the most recent regular meeting of the Committee.

   B. Any swap drawing proposed by a foreign bank exceeding the larger of (i) $200 million or (ii) 15 percent of the size of the swap arrangement.

3. The Manager shall also consult with the Subcommittee or the Chairman about proposed swap drawings by the System and about any operations that are not of a routine character.

By unanimous vote, the Committee reduced from $20 billion to $5 billion the amount of eligible foreign currencies that the System was prepared to "warehouse" for the U.S. Treasury and the Exchange Stabilization Fund (ESF). Warehousing involves spot purchases of foreign currencies from the U.S. Treasury or the ESF and simultaneous forward sales of the same currencies to the U.S. Treasury or the ESF at the then-current forward market rates. The effect of warehousing is to supplement the U.S. dollar resources of the U.S. Treasury and the ESF for financing the purchase of foreign currencies and related international operations. The agreement had been enlarged from $5 billion to $20 billion in early 1995 to facilitate U.S. participation in the Multilateral Program to Restore Financial Stability in Mexico. No use of the warehousing facility had been made by the U.S. Treasury or the ESF during this period, and in light of Mexico's repayment to the U.S. Treasury of all the financing provided under the Program and the termination of that Program, the Committee agreed that the size of the warehousing arrangement should revert to $5 billion.

The Report of Examination of the System Open Market Account, conducted by the Board's Division of Reserve Bank Operations and Payment Systems as of the close of business on October 31, 1996, was accepted.

By unanimous vote, the Program for Security of FOMC Information was amended to update the document with regard to certain security classifications, access to FOMC information, and attendance at FOMC meetings.

On January 23, 1997, the continuing rules and other standing instructions of the Committee were distributed with the advice that, in accordance with procedures approved by the Committee, they were being called to the Committee's attention before the February 4–5 organization meeting to give members an opportunity to raise any questions they might have concerning them. Members were asked to indicate if they wished to have any of the documents in question placed on the agenda for consideration at this meeting, and no requests for consideration were received.

By unanimous vote, the minutes of the meeting of the Federal Open Market Committee held on December 17, 1996, were approved. The Committee also discussed its long-standing practice of releasing the minutes a few days after the meeting at which they were approved, usually on the following Friday. The members agreed with a proposal to advance the normal release to Thursday to facilitate the dissemination and public understanding of these decisions.

The Manager of the System Open Market Account reported on developments in foreign exchange markets since the meeting on December 17, 1996. There were no transactions in foreign currencies for System account during this period, and thus no vote was required of the Committee.

The Manager also reported on developments in domestic financial markets and on System open market transactions in government securities and federal agency obligations during the period December 18, 1996, through February 4, 1997. By unanimous vote, the Committee ratified these transactions.

The Manager advised the Committee that the anticipated pattern of reserve needs was such that he might want to add considerably to the System's outright holdings of U.S. government securities over the coming intermeeting period. By unanimous vote, the Committee amended paragraph 1(a) of the Authorization for Domestic Open Market Operations to raise the limit on intermeeting changes in such holdings from $8 billion to $12 billion for the period ending with the close of business on the date of the next meeting, March 25, 1997.

The Committee then turned to a discussion of the economic and financial outlook, the ranges for the growth of money and debt in 1997, and the implementation of monetary policy over the intermeeting period ahead. A summary of the economic and financial information available at the time of the meeting and of the Committee's discussion is provided below, followed by the domestic policy directive that was approved by the Committee and issued to the Federal Reserve Bank of New York.

The information reviewed at this meeting suggested that the growth of the economy had strengthened markedly in the fourth quarter of 1996. To a large extent the gain in final demand during the quarter reflected a surge in exports, but consumer spending also increased substantially after having risen at a much reduced pace in the third quarter. Despite some slowing in the growth of business fixed investment and some easing in housing activity, the overall economy had expanded briskly as reflected in data on production and employment. The tightness in labor markets had persisted and was evidenced by some continued acceleration in labor compensation in the fourth quarter. There was no discernible change in the underlying trend in price inflation, although a spurt in energy prices had resulted in faster increases in overall consumer and producer prices than in the third quarter.

Private payroll employment rose appreciably further in December after having recorded sizable increases over October and November. The gains remained widespread among employment categories and continued to be led by large advances in the services and trade industries. Aggregate hours of private production workers and the average workweek edged higher in the fourth quarter. The civilian unemployment rate was unchanged in December at 5.3 percent, its average level for the second half of the year.

Industrial production increased sharply in November and December. The gains in December were widely distributed across manufacturing industries but were held down by a steep decline in the output of utilities after a surge in November. The production of aircraft and parts extended a strong uptrend. The utilization of total manufacturing capacity rose considerably further in December, to a level slightly above its long-term average.

Consumer spending registered a sizable increase over the fourth quarter after having grown little during the summer. In December total nominal retail sales rose considerably following a small decline in November. The December increases were spread across all major categories except for some further decline in sales of building materials and supplies. The most recent data on services expenditures pointed to moderate advances in October and November. Surveys indicated that consumer confidence had remained elevated in late 1996 and early 1997.

Housing starts fell appreciably in December, evidently reflecting unusually adverse weather conditions in several parts of the country, and were down somewhat for the fourth quarter as a whole. The declines were concentrated in single-family units. Permits for new home construction were little changed in December but edged lower for the fourth quarter as a whole. Available data indicated a somewhat slower pace of sales of new and existing homes in the fourth quarter.

Growth of business fixed investment moderated considerably in the fourth quarter after having advanced sharply in the previous quarter. The slowdown reflected a small decline in spending on producer durable equipment that was more than offset by an apparent surge in outlays for nonresidential structures. Growth in spending on office, computing, and communications equipment slowed somewhat from the third-quarter pace but remained on a steep uptrend. Business investment in transportation equipment was weak in the fourth quarter, as sales of heavy trucks fell further and work stoppages at a major manufacturer prompted cuts in fleet auto sales in October and November.

Business inventory investment picked up somewhat on average in October and November, with most of the increase occurring in manufacturing. Trade inventories increased moderately on balance over the two-month period. Reflecting considerable strength in shipments and sales, however, inventory–sales ratios for most industries and trade groupings edged lower from their third-quarter levels.

The nominal deficit on U.S. trade in goods and services narrowed considerably in October and November from its rate in the third quarter. Nearly all the improvement was accounted for by a very large increase in exports of goods and services. The rise was spread among all major trade categories except automotive products. Economic activity in the major foreign industrial countries appeared to have continued to expand at a moderate rate on average in the fourth quarter. Available indicators suggested relatively strong economic performances in Japan, Canada, and the United Kingdom and slower growth in the major continental European countries. Further expansion was reported for several large Latin American and some Asian economies.

Recent data pointed to little change in underlying inflation trends. Overall consumer prices had continued under upward pressure in November and December, boosted by large advances in energy prices. Excluding food and energy items, consumer prices rose modestly over the two months and increased less over the twelve months ending in December than over the previous twelve months. At the producer level, a similar pattern prevailed in prices of finished goods, and there was no evidence of increased price pressures at earlier stages of production. Worker compensation as measured by the employment cost index (ECI) and average hourly earnings of production and nonsupervisory workers rose considerably further during the closing months of 1996. For the year, both measures were up appreciably more than in 1995, though much of the acceleration in the ECI occurred in the first half of the year.

At its meeting on December 17, 1996, the Committee issued a directive that called for maintaining the existing degree of pressure on reserve positions. The directive included a bias toward the possible firming of reserve conditions to reflect a consensus among the members that the risks remained biased toward higher inflation and that the next policy move was more likely to be toward some tightening than toward easing. In this regard, the directive stated that in the context of the Committee's long-run objectives for price stability and sustainable economic growth, and giving careful consideration to economic, financial, and monetary developments, somewhat greater reserve restraint would be acceptable and slightly lesser reserve restraint might be acceptable during the intermeeting period. The reserve conditions associated with this directive were expected to be consistent with some slowing of the growth of M2 and M3 over coming months.

Open market operations during the intermeeting period continued to be directed toward maintaining the existing degree of pressure on reserve positions.

The federal funds rate rose briefly in response to year-end pressures, but it otherwise tended to remain close to the 5¼ percent level expected with an unchanged policy stance. Other short-term interest rates generally were unchanged to slightly higher over the intermeeting period. Rates on intermediate- and long-term securities edged higher on balance in reaction to incoming data on economic activity that were on the firm side of market expectations; the increases in such rates appeared to be tempered, however, by favorable market reactions to new data on wages and prices. The generally positive news on economic growth and inflation along with favorable reports on earnings appeared to reinforce the optimism of equity market investors, and major indexes of stock prices increased markedly further over the intermeeting period.

In foreign exchange markets, the trade-weighted value of the dollar in terms of the other G-10 currencies rose substantially over the intermeeting period. The rise, which was most pronounced against the Japanese yen and continental European currencies, appeared to reflect market perceptions of unexpectedly strong economic growth in the United States and a risk of faltering growth in the other countries. The dollar appreciated less against sterling and declined somewhat against the Canadian dollar in apparent response to expectations of relative strength in the economies of those countries.

After having grown at a considerably faster rate in the fourth quarter, M2 and M3 apparently increased at a more moderate but still brisk pace in January. The expansion of both aggregates likely was boosted by strong income growth, and the relatively rapid expansion of M3 reflected heavy bank reliance on the managed liabilities in M3 to fund robust loan growth. From the fourth quarter of 1995 to the fourth quarter of 1996, M2 was estimated to have grown at a rate near the upper end of the Committee's annual range and M3 at a rate appreciably above the top of its range. Total domestic nonfinancial debt had expanded moderately on balance over recent months and was estimated to have grown last year at a rate near the midpoint of its range.

The staff forecast prepared for this meeting suggested that the expansion would be sustained at a rate a bit above the economy's estimated growth potential. The increase in consumer spending was projected to moderate somewhat from its pace in the fourth quarter to a rate generally in line with the expected rise in disposable income. Homebuilding was forecast to decline somewhat but to stabilize at a relatively high level in the context of continued income growth and the generally favorable cash flow affordability of home ownership. Business spending on equipment and structures was projected to expand less rapidly in light of some anticipated slowing in the growth of sales and profits. Fiscal policy and the external sector were expected to exert small restraining influences on economic activity over the year ahead. With resource utilization high and rising, consumer price inflation, as measured by the CPI excluding the relatively volatile food and energy components of the index, was forecast to increase slightly this year in the context of some further pickup in the growth of labor compensation that would include another legislated rise in the federal minimum wage.

In the Committee's discussion of current and prospective economic developments, members commented that the robust performance of the economy in the fourth quarter partly reflected some sources of strength, notably a surge in exports, that were evidently temporary, and they anticipated substantial moderation in the pace of the expansion over the period ahead. The outlook was subject to considerable uncertainty, but as they assessed the numerous factors bearing on prospective developments, the members generally concluded as they had at previous meetings that further growth in aggregate demand at a rate averaging near or a bit above the economy's potential remained a reasonable expectation. Many observed, however, that the risks to such an outlook appeared to be tilted to the upside. The strength of the expansion in the fourth quarter, and in fact over 1996 as a whole, had heightened concerns that the economy had considerable forward momentum at a time when it was already operating at a level, especially with regard to labor resources, that could tend to generate rising inflationary pressures. Indeed, in the view of at least some members, growth of aggregate demand in line with increases in potential output posed a risk of rising price inflation because the recent relatively favorable price performance was seen in this view as reflecting at least in part the behavior of special factors that could dissipate over the projection horizon.

In keeping with the practice at meetings when the Committee establishes its long-run ranges for the growth of money and debt aggregates, the members of the Committee and the Federal Reserve Bank presidents not currently serving as members had provided individual projections of the growth in real and nominal GDP, the rate of unemployment, and the rate of inflation for the year 1997. The forecasts of the rate of expansion in real GDP had a central tendency of 2 to 2¼ percent and a full range of 2 to 2½ percent. The projections of the civilian unemployment rate associated with these growth expectations were all in a range of 5¼ to 5½ percent for the fourth quarter of the year. With regard to nominal GDP growth in 1997, the forecasts were mainly in a range of 4¼ to 4¾ percent, with an overall range of 4¼ to 5¼ percent. Nearly all the members anticipated a small decline in the rate of inflation in 1997, as measured by the consumer price index, from that recorded in 1996. Specifically, the projections converged on rates of 2¾ to 3 percent and a full range of 2¾ to 3½ percent in 1997. These forecasts took account of expected developments in the food and energy sectors and further technical improvements in the index by the Bureau of Labor Statistics, both of which were expected to trim the reported rate. The projections were based on individual views concerning what would be an appropriate policy over the projection horizon to further progress toward the Committee's goals.

In their review of developments in key sectors of the economy, members observed that the available data and anecdotal information indicated considerable strength in consumer spending in recent months, and they referred to a number of underlying factors that should help to sustain at least moderate further growth in such spending. The latter included the solid expansion in employment and incomes, the increased financial wealth of many consumers, and the high level of consumer confidence as indicated by recent surveys. However, members also cited some factors that would tend to restrain the growth in consumer spending. Among these factors were the effects of the high level of consumer debt and rising repayment problems on both the willingness of households to borrow and of financial intermediaries to lend, the likely absence of pent-up demands after an extended period of expansion, and the possibility of a setback in the stock market. It was difficult to evaluate how these differing factors would on balance affect consumer spending, but the members concluded that the consumer sector was likely to provide important support for sustained economic expansion.

The growth in business capital spending was expected to moderate somewhat in 1997 in association with slower growth in sales, profits, and cash flows. It also seemed likely after several years of robust investment expenditures that many business firms now had high levels of up-to-date capital stock relative to planned production. Members referred, however, to a number of favorable factors that should continue to support at least moderate further growth in business investment, including the attractive pricing of and ongoing rapid technological improvements in computer and communications equipment and the wide availability of equity and debt financing on favorable terms to business firms. Members also reported that commercial building activity had improved in many areas. Some noted a tendency to underestimate the strength of overall business investment in recent years, including the stimulus provided by efforts to improve productivity in highly competitive markets.

While indicators of housing activity had been somewhat erratic over the past several months, members sensed a somewhat softer tone on balance in this sector of the economy. This assessment was supported by anecdotal observations in several regions across the country. Against the background of the increase that had occurred earlier in mortgage financing costs and forecasts of some slowing in the growth of jobs and incomes, the housing sector was likely to weaken slightly over the coming year, but some members commented that surprises on the upside of current forecasts, as in 1996, could not be ruled out.

Fiscal policy and foreign trade also were seen as likely to exert some modest restraint on overall economic activity. Federal purchases of goods and services still appeared to be on a declining trend. Although fiscal policy negotiations were likely to be difficult and their outcome was uncertain, members felt that there was some basis for anticipating the enactment of further legislation this year to help bring the federal budget into eventual balance. The large increase in exports in the fourth quarter clearly was associated with temporary developments, and net exports were expected to weaken this year, reflecting both some reversal of recent developments and the earlier appreciation of the dollar. Some members reported that business contacts had already communicated concerns about increased competitive pressures from imports because of the rise in the foreign exchange value of the dollar.

Members commented that inflation had remained remarkably subdued, but they expressed considerable concern about the risks of rising inflation in the context of high levels of resource use. They referred in particular to statistical indications, supported by anecdotal reports from around the nation, of very tight conditions in labor markets and some upward pressures on wages. Thus far, the rise in compensation had been held down by diminishing increases in worker benefit costs, and productivity gains also appeared to have had a favorable effect on unit labor costs. In addition, the increases in wages themselves had continued to be restrained by apparent worker concerns about job security. To date, there was no evidence that pressures stemming from tight labor markets had been passed through to a measurable extent to higher prices.

While the absence of increasing price inflation was a welcome development, members were concerned that the break with historical patterns might not persist. If labor markets remained under pressure, nominal compensation costs were likely to pick up at some point as one-time savings in worker benefit costs ran out and as workers became less willing to trade off lower wages for increased security; such a development would foster increases in labor costs that ultimately would feed through to higher prices. The members did not anticipate a sudden surge in inflation, but many expressed concern about the possibility of a gradual upcreep in coming quarters that might become more considerable later. They generally expected a small decline in overall price inflation this year, reflecting favorable developments in food and energy and, for the CPI, further technical improvements by the Bureau of Labor Statistics; however, they believed that the risks to their forecasts were in the direction of greater inflation, and several noted in particular that projected declines in energy prices might not materialize as soon or to the extent assumed in many forecasts.

In keeping with the requirements of the Full Employment and Balanced Growth Act of 1978 (the Humphrey–Hawkins Act), the Committee reviewed the ranges for growth of the monetary and debt aggregates in 1997 that it had established on a tentative basis at its meeting in July 1996. Those ranges included expansion of 1 to 5 percent for M2 and 2 to 6 percent for M3, measured from the fourth quarter of 1996 to the fourth quarter of 1997. The monitoring range for growth of total domestic nonfinancial debt was provisionally set at 3 to 7 percent for 1997. The tentative ranges for 1997 were unchanged from the actual ranges adopted for 1995 (in July of that year for M3) and 1996.

In reviewing the tentative ranges, the members took note of a staff projection indicating that M2 and M3 likely would grow in 1997 at rates close to the upper limit of those ranges, given the Committee's expectations for the performance of the economy and prices and assuming no major changes in interest rates. The staff analysis anticipated that the velocities of the broad monetary aggregates would continue to behave in the relatively stable and predictable manner that had re-emerged in the last few years and that was closer to historical norms than had been the case in the early 1990s.

The greater measure of predictability in velocity recently was an encouraging development, but in view of the substantial changes in financial markets and the increased availability of investment alternatives it would be premature to assume that the pattern would necessarily continue going forward. Given the substantial uncertainty still attached to projections of money growth consistent with the Committee's basic objectives for monetary policy, the members agreed that there was no firm basis for changing the tentative ranges set in July 1996. Adopting higher ranges, which would be more closely centered on money growth thought likely to be consistent with the Committee's expectations for economic activity and prices, could be misinterpreted as indicating that the Committee had become much more confident of the predictability of velocity and was placing greater emphasis on M2 and M3 as gauges of the thrust of monetary policy. One member, while agreeing with this assessment, emphasized that a continuation of a stable and predictable pattern of velocity behavior would raise the question as to whether the Committee should return to setting ranges consistent with its expectations for economic developments. Nonetheless, from a longer-run perspective, the tentative ranges readily encompass rates of growth of M2 and M3 that, if velocity were to behave in line with historical experience, could be expected to be associated with approximate price stability and a sustainable rate of real economic growth. In that regard, they continue to serve the useful purpose of benchmarking money growth consistent with the Committee's long-run goal of price stability.

At the conclusion of its discussion, the Committee voted to approve without change the tentative ranges for 1997 that it had established in July of last year. In keeping with its usual procedures under the Humphrey–Hawkins Act, the Committee would review its ranges at midyear, or sooner if interim conditions warranted, in light of the growth and velocity behavior of the aggregates and ongoing economic and financial developments. Accordingly, the following statement of longer-run policy for 1997 was approved for inclusion in the domestic policy directive:

The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. In furtherance of these objectives, the Committee at this meeting established ranges for growth of M2 and M3 of 1 to 5 percent and 2 to 6 percent respectively, measured from the fourth quarter of 1996 to the fourth quarter of 1997. The monitoring range for growth of total domestic nonfinancial debt was set at 3 to 7 percent for the year. The behavior of the monetary aggregates will continue to be evaluated in the light of progress toward price level stability, movements in their velocities, and developments in the economy and financial markets.

Votes for this action: Messrs. Greenspan, McDonough, Broaddus, Guynn, Kelley, Meyer, Moskow, Parry, Mses. Phillips and Rivlin. Votes against this action: None. Absent and not voting: Mr. Lindsey and Ms. Yellen.

In the Committee's discussion of policy for the intermeeting period ahead, all the members favored or could support a proposal to maintain an unchanged policy stance; the members also strongly supported the retention of a bias toward restraint. An unchanged policy seemed appropriate with inflation still quiescent, with few signs of emerging price pressures, with growth in economic activity seen as likely to moderate appreciably from the unexpectedly strong and unsustainable pace of the fourth quarter, and with considerable uncertainty about future inflationary developments. However, the members emphasized that the extent of the slowdown in economic expansion was unclear and that the persisting, or even greater, tightness of labor markets, coupled with potentially faster growth in worker benefits and diminishing worker insecurity, could put added upward pressure on labor costs and induce some increase in price inflation over time. Even so, most members thought that inflation likely would remain contained for some period ahead and that any strengthening in inflation pressures probably would be gradual, allowing the Committee to respond in a timely manner. Several also commented that a tightening policy action was not generally anticipated in financial markets, and a move at this time could have exaggerated repercussions. A few members emphasized, however, that the recent surge in economic activity had raised the probability that the level of economic output was now above the economy's long-run potential, and without a significant slowing in economic growth, inflationary pressures were more likely to increase over the forecast horizon. While an immediate tightening of policy would help to forestall such a buildup of pressures, the members agreed that current uncertainties about the outlook for both the rate of expansion and inflation warranted a continuing "wait and see" policy stance, or at least made such a policy acceptable at this juncture.

In their discussion of possible adjustments to policy during the intermeeting period, the members recognized that an asymmetric directive tilted toward tightening was consistent with their general view that the risks were now more clearly in the direction of an upward trend in inflation. They agreed that the current environment called for careful monitoring of new developments and for prompt action by the Committee to counter any tendency for price inflation to rise and for higher inflation expectations to become embedded in financial markets and economic decisionmaking more generally. Indeed, in the interest of fostering a continuation of sustainable growth of the economy, it would be desirable to tighten before any sign of actual higher inflation were to become evident.

At the conclusion of the Committee's discussion, all the members indicated that they supported a directive that called for maintaining the existing degree of pressure on reserve positions and that retained a bias toward the possible firming of reserve conditions during the intermeeting period. Accordingly, in the context of the Committee's long-run objectives for price stability and sustainable economic growth, and giving careful consideration to economic, financial, and monetary developments, the Committee decided that somewhat greater reserve restraint would be acceptable and slightly lesser reserve restraint might be acceptable during the intermeeting period. The reserve conditions contemplated at this meeting were expected to be consistent with some moderation in the expansion of M2 and M3 over coming months.

The Federal Reserve Bank of New York was authorized and directed, until instructed otherwise by the Committee, to execute transactions in the System Account in accordance with the following domestic policy directive:

The information reviewed at this meeting suggests that the economic expansion strengthened markedly in the fourth quarter. Private nonfarm payroll employment increased appreciably further in December after sizable gains over October and November. The civilian unemployment rate remained at 5.3 percent in December. Industrial production rose sharply in November and December. Consumer spending posted a large increase in the fourth quarter after a summer lull. Housing activity moderated somewhat over the closing months of the year. Growth in business fixed investment slowed substantially in the fourth quarter after a sharp rise in the third quarter. The nominal deficit on U.S. trade in goods and services narrowed considerably in October and November from its rate in the third quarter. Advances in labor compensation trended up in 1996, but price inflation generally diminished apart from enlarged increases in food and energy prices.

Most market interest rates have changed little or risen slightly since the Committee meeting on December 17, 1996. In foreign exchange markets, the trade-weighted value of the dollar in terms of the other G-10 currencies has increased substantially over the intermeeting period.

Growth of M2 and M3 strengthened considerably in the fourth quarter and appeared to have continued at a fairly brisk, though diminished, pace in January. From the fourth quarter of 1995 to the fourth quarter of 1996, M2 is estimated to have grown near the upper end of the Committee's annual range and M3 well above the top of its range. Total domestic nonfinancial debt has expanded moderately on balance over recent months and is estimated to have grown last year near the midpoint of its range.

The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. In furtherance of these objectives, the Committee at this meeting established ranges for growth of M2 and M3 of 1 to 5 percent and 2 to 6 percent respectively, measured from the fourth quarter of 1996 to the fourth quarter of 1997. The monitoring range for growth of total domestic nonfinancial debt was set at 3 to 7 percent for the year. The behavior of the monetary aggregates will continue to be evaluated in the light of progress toward price level stability, movements in their velocities, and developments in the economy and financial markets.

In the implementation of policy for the immediate future, the Committee seeks to maintain the existing degree of pressure on reserve positions. In the context of the Committee's long-run objectives for price stability and sustainable economic growth, and giving careful consideration to economic, financial, and monetary developments, somewhat greater reserve restraint would or slightly lesser reserve restraint might be acceptable in the intermeeting period. The contemplated reserve conditions are expected to be consistent with some moderation in the expansion of M2 and M3 over coming months.

Votes for this action: Messrs. Greenspan, McDonough, Broaddus, Guynn, Kelley, Meyer, Moskow, Parry, Mses. Phillips and Rivlin. Votes against this action: None. Absent and not voting: Mr. Lindsey and Ms. Yellen.

It was agreed that the next meeting of the Committee would be held on Tuesday, March 25, 1997.

The meeting adjourned at 11:35 a.m.

Donald L. Kohn
Secretary

Meeting Held on March 25, 1997

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Tuesday, March 25, 1997, at 9:00 a.m.

Present:

Mr. Greenspan, Chairman
Mr. McDonough, Vice Chairman
Mr. Broaddus
Mr. Guynn
Mr. Kelley
Mr. Moskow
Mr. Meyer
Mr. Parry
Ms. Phillips
Ms. Rivlin

Messrs. Hoenig, Jordan, Melzer, and Ms. Minehan, Alternate Members of the Federal Open Market Committee

Messrs. Boehne, McTeer, and Stern, Presidents of the Federal Reserve Banks of Philadelphia, Dallas, and Minneapolis respectively

Mr. Kohn, Secretary and Economist
Mr. Bernard, Deputy Secretary
Mr. Coyne, Assistant Secretary
Mr. Gillum, Assistant Secretary
Mr. Mattingly, General Counsel
Mr. Baxter, Deputy General Counsel
Mr. Prell, Economist
Mr. Truman, Economist

Messrs. Eisenbeis, Goodfriend, Hunter, Lindsey, Mishkin, Siegman, and Stockton, Associate Economists

Mr. Fisher, Manager, System Open Market Account

Mr. Winn, Assistant to the Board, Office of Board Members, Board of Governors
Mr. Ettin, Deputy Director, Division of Research and Statistics, Board of Governors
Messrs. Madigan and Simpson, Associate Directors, Divisions of Monetary Affairs and Research and Statistics respectively, Board of Governors
Mr. Hooper, Assistant Director, Division of International Finance, Board of Governors
Ms. Low, Open Market Secretariat Assistant, Division of Monetary Affairs, Board of Governors

Messrs. Dewald, Hakkio, Lang, Rolnick, and Rosenblum, Senior Vice Presidents, Federal Reserve Banks of St. Louis, Kansas City, Philadelphia, Minneapolis, and Dallas respectively

Messrs. Altig, Bentley, Judd, and Kopcke, Vice Presidents, Federal Reserve Banks of Cleveland, New York, San Francisco, and Boston respectively

By unanimous vote, the minutes of the meeting of the Federal Open Market Committee held on February 4–5, 1997, were approved.

The Manager of the System Open Market Account reported on recent developments in foreign exchange markets. There were no System open market transactions in foreign currencies during the period since the meeting on February 4–5, 1997, and thus no vote was required of the Committee.

The Manager also reported on developments in domestic financial markets and on System open market transactions in U.S. government securities and federal agency obligations during the period February 5, 1997, through March 24, 1997. By unanimous vote, the Committee ratified these transactions.

The Manager advised the Committee that he continued to anticipate a pattern of reserve needs that might require another unusually large addition to the System's outright holdings of U.S. government securities during the relatively long intermeeting period ahead. The limit on increases in outright holdings between meetings had been raised to $12 billion at the February meeting, and the Manager requested that the higher limit be retained for the upcoming period. By unanimous vote, the Committee amended paragraph 1(a) of the Authorization for Domestic Open Market Operations to raise the limit on intermeeting changes in such holdings from $8 billion to $12 billion for the period ending with the close of business on the date of the next meeting, May 20, 1997.

The Committee then turned to a discussion of the economic outlook and the implementation of monetary policy over the intermeeting period ahead. A summary of the economic and financial information available at the time of the meeting and of the Committee's discussion is provided below, followed by the domestic policy directive that was approved by the Committee and issued to the Federal Reserve Bank of New York.

The information reviewed at this meeting suggested that the economy had continued to expand at a relatively robust pace in early 1997 after having strengthened markedly in the fourth quarter of 1996. Much of the more recent growth reflected further acceleration in consumer spending, but business capital expenditures, housing activity, and an upturn in inventory investment also had contributed to the recent increase in total expenditures. By contrast, available data pointed to a sharp drop in net exports after a surge in the fourth quarter. To meet the strong aggregate demand, employment had recorded another large advance in early 1997 and industrial production had risen somewhat further. The underlying trend in consumer price inflation had remained subdued, but the increase in average hourly earnings had continued to edge higher early this year.

Private nonfarm payroll employment rose substantially further in January and February. The gains continued to be led by sizable advances in the services and trade industries. Employment in construction increased considerably over the two months, largely because of unseasonably warm weather across much of the country in February that led to an earlier-than-usual pickup in building activity. Aggregate hours of private production workers, which were also affected by changing weather conditions, were up appreciably on balance over the two months, and the average workweek increased considerably, reaching a new recent high in February. The civilian unemployment rate, at 5.3 percent in February, was unchanged from its average level in the second half of 1996.

Industrial production rose appreciably in February after having declined slightly in January. The February advance resulted from a surge in the manufacturing of durable goods that was only partly offset by a plunge in the output of utilities associated with unseasonably mild weather in that month. The utilization of total manufacturing capacity was unchanged on balance over the two months at a level slightly above its long-term average.

Consumer spending strengthened considerably further in early 1997 after having registered a sizable increase over the fourth quarter. Nominal retail sales rose sharply in January and February. The gains over the two months were concentrated in sales of durable goods, including motor vehicles and building materials. Spending on services rose strongly in January (latest data) but may have moderated in February when milder-than-normal weather held down heating costs. Recent surveys indicated that consumer confidence had risen to the highest levels in many years.

Housing construction rose sharply in February after two months of relatively depressed activity. On balance, various indicators of housing activity had been mixed over the past several months and did not suggest any clear trend in spending for new housing.

Recent trends in orders and shipments pointed to a sizable further rise in outlays for producers' durable equipment in early 1997, largely reflecting continued rapid growth in purchases of computers and some further increase in spending for communications equipment. Expenditures for other types of equipment remained little changed. In the nonresidential construction sector, trends in contracts suggested some further spending gains in most market segments after strong advances in the fourth quarter. Manufacturing and trade inventories rose somewhat in January, roughly offsetting small declines over the previous two months. With sales and shipments rising rapidly in January, inventory–sales ratios for a wide range of industries dropped further from already low levels.

The nominal deficit on U.S. trade in goods and services widened substantially in January from its temporarily depressed rate in the fourth quarter. Nearly all the deterioration in the trade balance reflected a sharp rise in imports; that increase was largely the result of a rebound in automotive shipments from Canada, which had been temporarily reduced by a strike. Recent information on economic activity in the G-7 countries suggested continued expansion at a moderate rate on average in early 1997, but rates of expansion had continued to diverge among those economies. Growth in output still appeared to be relatively strong in Japan, Canada, and the United Kingdom, while much weaker economic performances were indicated for the major continental European countries. The economies of the major developing countries in Latin America and eastern Asia apparently continued to expand in late 1996.

Data for January and February were consistent with the continuation of a subdued trend in underlying price inflation. Overall consumer price inflation moderated somewhat over the two months from its pace in the fourth quarter; smaller increases in energy prices were an important factor in the slowdown, but prices of consumer items other than food and energy also advanced at a slower rate over the first two months of the year. For the twelve months ending in February, consumer prices excluding food and energy rose somewhat less than they had over the preceding twelve months; a development contributing importantly to the deceleration was a smaller rise in non-oil import prices associated with the appreciation of the dollar. At the producer level, overall prices of finished goods declined somewhat in January and February, reflecting an appreciable drop in the food and energy components. For the twelve months ending in February, the increase in the overall index of finished goods prices was little changed from that over the preceding twelve months, but excluding food and energy prices, which had registered sizable advances in 1996, the rise was considerably smaller over the latest twelve-month period. At early stages of processing, however, some producer prices had moved up in recent months. Average hourly earnings of production and nonsupervisory workers posted small further increases in January and February but were up appreciably more over the twelve months ending in February than over the preceding twelve months.

At its meeting on February 4–5, 1997, the Committee issued a directive that called for maintaining the existing degree of pressure on reserve positions. The directive included a bias toward the possible firming of reserve conditions, reflecting a consensus among the members that the risks were clearly in the direction of an upward trend in inflation and that the next policy move was more likely to be toward some tightening than toward easing. In this regard, the directive stated that in the context of the Committee's long-run objectives for price stability and sustainable economic growth, and giving careful consideration to economic, financial, and monetary developments, somewhat greater reserve restraint would be acceptable and slightly lesser reserve restraint might be acceptable during the intermeeting period. The reserve conditions associated with this directive were expected to be consistent with some slowing of the growth of M2 and M3 over coming months.

Over the period since the February meeting, open market operations were directed toward maintaining the existing degree of pressure on reserve positions. Federal funds continued to trade mainly at rates close to the 5¼ percent level expected with an unchanged policy stance, though the rate did at times fall below that level in conjunction with unanticipated shortfalls in demands for excess reserves. Most other market interest rates rose somewhat over the intermeeting period in apparent response to indications of stronger-than-expected economic activity, perceptions that the Federal Reserve had become more concerned about a possible buildup in inflation pressures, and perhaps disappointment over the prospects for legislation to reduce the federal budget deficit. In these circumstances, expectations built that monetary policy would be tightened. The rise in most market interest rates was accompanied by slight declines in a number of major indexes of stock market prices, although stock prices in some industries posted more pronounced declines.

In foreign exchange markets, the trade-weighted value of the dollar in terms of the other G-10 currencies rose further over the intermeeting period. The dollar's appreciation appeared to reflect spreading perceptions of a relatively strong U.S. expansion and associated increases in U.S. interest rates compared with those abroad. The dollar's rise was most pronounced against the continental European currencies.

Growth of M2 moderated somewhat in January and February from a brisk pace in late 1996, while expansion of M3 remained rapid in both months. Data for the first part of March suggested diminished growth of both aggregates. The appreciable further expansion of these broad aggregates thus far this year probably continued to reflect elevated income growth, and the relative strength of M3 was associated to an important extent with heavy bank reliance on large-denomination time deposits to fund robust asset growth. M3 also continued to be boosted by the rapid growth of money market mutual funds. The expansion of total domestic nonfinancial debt appeared to have slowed in the early part of the year in conjunction with reduced borrowing by both federal and state governments, which were drawing down cash balances.

The staff forecast prepared for this meeting suggested that the expansion in economic activity would slow in coming quarters to a pace somewhat above that of the economy's estimated potential and would moderate a bit further in 1998. Growth in consumer spending was expected to decline appreciably from its recent pace but to remain fairly brisk over the quarters ahead, supported by further projected gains in employment and incomes. Expansion in business spending on equipment and structures also was projected to moderate, but to a still relatively high rate, in association with smaller increases in sales and profits. Housing construction was forecast to drift lower over coming quarters, partly reflecting the rise that already had occurred in mortgage interest rates. The staff continued to anticipate that fiscal policy and the external sector would exert mildly restraining effects on economic activity over the year ahead. With resource utilization high and labor compensation rising, core consumer price inflation was forecast to increase slightly over the year ahead.

In the Committee's discussion of current and prospective economic developments, members referred to the widespread statistical and anecdotal evidence that the surprising strength in economic activity over the closing months of 1996 was persisting in 1997. Some observed that it was difficult to detect signs of weakness or imbalances in domestic sectors of the economy. While the members believed that some slowing in the expansion was inevitable, they felt that substantial uncertainty surrounded the timing and extent of such slowing in the quarters ahead. Continued growth near, or even somewhat below, the recent pace would raise resource utilization rates further from their already high levels. Although labor markets already were tight, inflation had remained relatively subdued, and there were no signs in price data that it was picking up. However, the risks of a rise in inflation down the road had increased appreciably as a result of the strength of aggregate demand and the increase in pressures on resources that likely would accompany it absent a firming in financial conditions.

In their discussion of the outlook for spending in key sectors of the economy, members emphasized the strength of consumer spending in recent months. They noted that anecdotal reports from numerous parts of the country and surveys indicating very high levels of consumer confidence tended to confirm statistical evidence of an ebullient consumer sector. While the recent surge in consumer demand probably was supported mainly by rapid growth in employment and labor income, it seemed possible that consumers also were responding increasingly to the run-up in household net worth stemming from the earlier buoyant performance of the stock market. The effects of rising financial wealth on consumer spending were difficult to isolate, and they were undoubtedly restrained by efforts to accumulate savings for future expenditures such as college expenses and retirement. Moreover, the constraints on spending imposed by the high debt burdens of many households tended to exert at least a partly offsetting influence on overall consumer spending. On balance, however, the members believed that the consumer sector was likely to provide major ongoing support to the expansion, though the increases in consumer spending probably would diminish in the context of more restrained growth in jobs and incomes. A number of members expressed the view, however, that the risks to such a forecast were in the direction of more robust consumer spending.

Business fixed investment, which had remained on a steep uptrend for an extended period, also was expected to provide continuing though moderating stimulus to the overall economic expansion. Growth in expenditures for business equipment was forecast to decline from the extraordinary pace of recent years, despite continuing brisk demand for computers and communications equipment. With regard to the outlook for nonresidential building activity, anecdotal reports from several regions pointed to a further pickup in commercial construction associated with declining vacancy rates, rising property values and rents, and readily available financing. Indeed, reports from a few areas indicated the emergence of speculative building activity. On the other hand, in some regions, signs of slowing nonresidential construction were reported.

Housing construction activity had fluctuated in recent months, largely in response to changing weather conditions, but such construction appeared to be little changed on balance. Recent anecdotal reports pointed to improving housing markets in several regions and to some easing in a few. Looking ahead, the members generally anticipated that housing activity would be maintained at a relatively high level, perhaps slightly below that prevailing on average in recent quarters, barring unanticipated developments in the broader economy or in financial markets. Although the rise that had occurred in mortgage interest rates was a somewhat inhibiting influence on the prospects for housing, favorable factors noted during the meeting included the ongoing effects of the large gains in stock market wealth, sizable increases in employment and incomes, and a still relatively favorable cash-flow affordability of home ownership.

The persisting efforts by business firms to economize on their inventories had reduced the latter to quite low levels in relation to sales. In the circumstances, current inventory levels were viewed as an upside risk to the expansion that could be triggered by unexpected strength in final demand. Absent an upside surprise in demand, inventories might be expected to remain a slightly positive factor in the economic outlook; and if growth in final demand were to moderate more than anticipated, the currently lean inventories could be viewed as minimizing the risks of accumulating weakness in the near term.

The outlook for fiscal policy remained one of modest restraint; on the basis of existing legislation, reductions were anticipated in constant-dollar purchases of goods and services by the federal government in fiscal years 1997 and 1998. A key element in the potential impact of fiscal policy was the uncertain outcome of the current effort to eliminate the federal deficit over time. Although success in that effort probably would have little effect on the government's budget position over the next few years, it likely would have some beneficial repercussions on business and consumer confidence and possibly also on financial markets. Financial markets would be especially positively affected by an agreement to reduce significantly the growth of entitlements, which would damp government spending and deficits over the longer run.

The unwinding in the early months of 1997 of special factors that had boosted net exports in the fourth quarter of 1996 was offsetting some of the effects on production of the persisting strength in domestic demand. Beyond the near term, the appreciated value of the dollar was expected to hold down net exports, restraining overall demand and growth. Some members observed in this regard that the deterioration in net exports might be substantial. While such an outcome would help to moderate inflationary pressures on domestic resources in coming quarters, it also would exacerbate the longer-term problem of very large foreign trade and current account deficits.

In their review of developments bearing on the outlook for inflation, members commented that the risks now seemed to be tilted more clearly toward higher inflation. They acknowledged that it was difficult to find indications of rising inflation in broad measures of consumer or GDP-related prices; indeed, such measures still could be viewed as consistent with a slightly declining trend in price inflation. Even so, prospects for a substantial period of economic expansion at a rate that exceeded the estimated growth of potential had generated increasing concerns of rising inflationary pressures in an economy that already was operating at high levels of resource utilization. Members observed in this regard that while there was little evidence of growing demand pressures on capital resources, the tightness in labor markets appeared to be intensifying. Indications of such a development included not only widespread anecdotal reports but a variety of data such as initial claims, insured unemployment, and help-wanted advertising. The rise in labor force participation to a high percentage of the working age population had helped to keep the unemployment rate from falling, but the unexpected increase in participation was itself suggesting tight conditions that were inducing marginal workers into the job market.

The data on worker compensation were somewhat mixed, but they suggested some acceleration on balance. Members noted that the damping effects of some temporary factors on labor costs could well begin to wane soon, if they had not already begun to do so. These included the possibility that job security concerns might be diminishing after an extended period of rapid job growth and low unemployment. The downward trend in medical cost increases might be in the process of shifting to a flat, if not a rising, gradient according to informed observers. Moreover, as the rise in labor force participation depleted the pool of available workers, less productive workers would tend to be hired, with adverse effects on productivity and costs. The members recognized that even though aggregate demand pressures seemed to be pressing increasingly on available producer resources, it was not possible to forecast with confidence when the period of favorable price behavior would end. Even so, it was clear that inflationary developments in the economy had become a matter of more urgent concern for monetary policy.

In light of this concern, in the Committee's discussion of policy for the intermeeting period ahead, the members supported or could accept a proposal to adjust policy toward a slightly less accommodative stance and to move to symmetry in the directive. They noted that continued relatively rapid growth of economic activity in the first quarter suggested greater persisting strength in demand than they had anticipated. With resource use already at high levels, further rapid growth risked greater pressures on resources and rising inflation. Although inflation remained remarkably subdued and any increase in inflationary pressures likely would tend to emerge only slowly, the strength in demand had developed against the backdrop of financial conditions that, broadly considered, were not substantially different from those now prevailing. In this situation, they saw a clear need for a preemptive policy action that would head off any pickup of inflation, and it was noted that a shift to a tighter policy stance would seem to pose little risk to the expansion. Indeed, by countering any tendency for inflation to rise and for higher inflation expectations to become embedded in financial markets and economic decisionmaking more generally, such action would help head off a more abrupt economic slowing, or even a downturn, and thereby would help sustain the expansion and preserve the firm labor markets and their associated benefits.

A few members argued that a more substantial tightening was needed at this juncture to provide a better calibrated response to the persisting strength of the economy and the related risk of intensifying inflationary pressures. In their view, a more vigorous action would lessen the need for tightening in the future and also would foster a financial setting that would be more conducive to sustained expansion. Other members acknowledged that a smaller policy move would have less effect in curbing inflationary pressures, but they felt that a cautious approach to policy was desirable at a time when the outlook for economic activity and inflation remained subject to substantial uncertainties. Some noted that a shift in policy direction, as the Committee was about to undertake, often can have exaggerated effects in financial markets, making it difficult to judge how much additional restraint, if any, might be needed.

In their discussion of possible adjustments to policy during the intermeeting period, a majority of the members favored a symmetric directive. While additional policy tightening might be needed at some point, it did not appear very likely that developments during the intermeeting period would require a further policy move. Some added that inflation remained quiescent and the near-term onset of an appreciable slowing of the expansion to a rate more in line with the economy's potential could not be ruled out. Accordingly, they felt that the directive should not establish a presumption about further near-term policy tightening. Other members believed that growth of the economy was not likely to slow enough to alleviate excess demands for resources and that additional tightening would be needed sooner rather than later to moderate inflationary pressures and prolong the expansion. In their view, the outlook called for vigilance and the maintenance of an asymmetric directive with a bias toward tightening, but they could accept a symmetric directive with careful monitoring of new developments for any signs of the need for prompt action.

At the conclusion of the Committee's discussion, all the members indicated that they supported or could accept a directive that called for a slight increase in the degree of pressure on reserve positions and that did not include a presumption about adjustments to policy during the intermeeting period. Accordingly, in the context of the Committee's long-run objectives for price stability and sustainable economic growth, and giving careful consideration to economic, financial, and monetary developments, the Committee decided that slightly greater reserve restraint or slightly lesser reserve restraint might be acceptable during the intermeeting period. The reserve conditions contemplated at this meeting were expected to be consistent with some moderation in the expansion of M2 and M3 over coming months.

The Federal Reserve Bank of New York was authorized and directed, until instructed otherwise by the Committee, to execute transactions in the System Account in accordance with the following domestic policy directive:

The information reviewed at this meeting suggests that relatively strong economic growth has continued in the first quarter. Private nonfarm payroll employment increased substantially further in January and February, and the civilian unemployment rate, at 5.3 percent in February, was unchanged from its level in the second half of 1996. Industrial production rose moderately on balance in January and February. Nominal retail sales increased sharply further over January and February after a considerable advance in the fourth quarter. Housing activity strengthened markedly over January and February, though much of the rise probably related to unusually favorable weather. Recent data on orders and contracts point to a further sizable gain in business fixed investment in the first quarter. The nominal deficit on U.S. trade in goods and services widened substantially in January from its temporarily depressed rate in the fourth quarter. Underlying price inflation has remained subdued.

Most market interest rates have risen somewhat since the Committee meeting on February 4–5, 1997. In foreign exchange markets, the trade-weighted value of the dollar in terms of the other G-10 currencies increased further over the intermeeting period.

Growth of M2 moderated somewhat in January and February from a brisk pace over the fourth quarter while the expansion of M3 remained relatively robust; data for the first part of March pointed to diminished growth in both aggregates. Total domestic nonfinancial debt has expanded moderately on balance over recent months.

The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. In furtherance of these objectives, the Committee at its meeting in February established ranges for growth of M2 and M3 of 1 to 5 percent and 2 to 6 percent respectively, measured from the fourth quarter of 1996 to the fourth quarter of 1997. The monitoring range for growth of total domestic nonfinancial debt was set at 3 to 7 percent for the year. The behavior of the monetary aggregates will continue to be evaluated in the light of progress toward price level stability, movements in their velocities, and developments in the economy and financial markets.

In the implementation of policy for the immediate future, the Committee seeks to increase slightly the existing degree of pressure on reserve positions. In the context of the Committee's long-run objectives for price stability and sustainable economic growth, and giving careful consideration to economic, financial, and monetary developments, slightly greater reserve restraint or slightly lesser reserve restraint might be acceptable in the intermeeting period. The contemplated reserve conditions are expected to be consistent with some moderation in the expansion of M2 and M3 over coming months.

Votes for this action: Messrs. Greenspan, McDonough, Broaddus, Guynn, Kelley, Meyer, Moskow, Parry, Mses. Phillips and Rivlin. Votes against this action: None.

It was agreed that the next meeting of the Committee would be held on Tuesday, May 20, 1997.

The meeting adjourned at 12:20 p.m.

Donald L. Kohn
Secretary

After the meeting, the following press release was issued:

The Federal Open Market Committee decided today to tighten money market conditions slightly, expecting the federal funds rate to rise ¼ percentage point to around 5½ percent.

This action was taken in light of persisting strength in demand, which is progressively increasing the risk of inflationary imbalances developing in the economy that would eventually undermine the long expansion.

In these circumstances, the slight firming of monetary conditions is viewed as a prudent step that affords greater assurance of prolonging the current economic expansion by sustaining the existing low inflation environment through the rest of this year and next. The experience of the last several years has reinforced the conviction that low inflation is essential to realizing the economy's fullest growth potential.

No change was made in the Federal Reserve discount rate, which remains at 5 percent.

Meeting Held on May 20, 1997

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Tuesday, May 20, 1997, at 9:00 a.m.

Present:

Mr. Greenspan, Chairman
Mr. McDonough, Vice Chairman
Mr. Broaddus
Mr. Guynn
Mr. Kelley
Mr. Moskow
Mr. Meyer
Mr. Parry
Ms. Phillips
Ms. Rivlin

Messrs. Hoenig, Jordan, Melzer, and Ms. Minehan, Alternate Members of the Federal Open Market Committee

Messrs. Boehne, McTeer, and Stern, Presidents of the Federal Reserve Banks of Philadelphia, Dallas, and Minneapolis respectively

Mr. Kohn, Secretary and Economist
Mr. Bernard, Deputy Secretary
Mr. Coyne, Assistant Secretary
Mr. Gillum, Assistant Secretary
Mr. Mattingly, General Counsel
Mr. Baxter, Deputy General Counsel
Mr. Prell, Economist
Mr. Truman, Economist

Messrs. Beebe, Eisenbeis, Goodfriend, Hunter, Lindsey, Mishkin, Promisel, Siegman, Slifman, and Stockton, Associate Economists

Mr. Fisher, Manager, System Open Market Account

Mr. Ettin, Deputy Director, Division of Research and Statistics, Board of Governors
Messrs. Madigan and Simpson, Associate Directors, Divisions of Monetary Affairs and Research and Statistics respectively, Board of Governors
Ms. Low, Open Market Secretariat Assistant, Division of Monetary Affairs, Board of Governors

Mr. Conrad, First Vice President, Federal Reserve Bank of Chicago
Messrs. Dewald, Hakkio, Ms. Krieger, Messrs. Lang, Rosenblum, and Sniderman, Senior Vice Presidents, Federal Reserve Banks of St. Louis, Kansas City, New York, Philadelphia, Dallas, and Cleveland respectively
Messrs. Cox, Rosengren, and Weber, Vice Presidents, Federal Reserve Banks of Dallas, Boston, and Minneapolis respectively

By unanimous vote, the Federal Open Market Committee approved the minutes of its meeting on March 25, 1997.

The Manager of the System Open Market Account reported on recent developments in foreign exchange markets. The Desk did not conduct any transactions in foreign currencies for System Account during the period since the latest meeting on March 25, 1997, and thus no vote was required of the Committee.

The Manager also reported on developments in domestic financial markets and on System open market transactions in government securities and federal agency obligations during the period March 25, 1997, through May 19, 1997. By unanimous vote, the Committee ratified these transactions.

The Committee then turned to a discussion of the economic outlook and the implementation of monetary policy over the intermeeting period ahead. A summary of the economic and financial information available at the time of the meeting and of the Committee's discussion is provided below, followed by the domestic policy directive that was approved by the Committee and issued to the Federal Reserve Bank of New York.

The information reviewed at this meeting suggested that the expansion of economic activity had slowed after having surged in late 1996 and earlier this year. Consumer spending appeared to be increasing at a considerably slower pace after the spurt in the first quarter, while business fixed investment remained on a strong uptrend, and the demand for housing seemed to be well maintained. Growth of labor demand had moderated somewhat from the rapid pace at the beginning of the year, but labor markets remained tight and worker compensation appeared to be accelerating gradually. Despite the upward drift in labor costs, underlying price inflation was still subdued.

Private nonfarm payroll employment rose at a considerably reduced pace over March and April, and the average workweek dropped from an unusually high rate in February and March to a more normal level in April. The services industries recorded further large gains in employment in March and April, but the number of jobs in manufacturing contracted in April and construction employment declined in both March and April. The civilian unemployment rate fell appreciably in April to 4.9 percent, and the labor force participation rate edged down from the record high reached in March.

Industrial production was unchanged in April after having recorded sizable increases in March and other recent months; declines in mining and manufacturing were offset by a large rise in utility output. The drop in manufacturing production reflected a sharp decline in the output of motor vehicles and parts that was largely related to the lagged effects of strike activity in recent months. The output of manufactured goods other than motor vehicles and parts rose moderately in April: the production of business equipment posted another solid gain while the output of consumer goods and construction supplies was unchanged. The rate of utilization of manufacturing capacity fell in April, reflecting the decline in motor vehicle output, but it remained relatively high.

Nominal retail sales were unchanged in March and declined in April after having increased rapidly in earlier months. Weaker sales of motor vehicles contributed to the overall sluggishness of retail activity in March and April, but spending on many other categories of goods, both durable and nondurable, also was down over the two-month period after having previously grown strongly. Expenditures on services advanced further through March (latest available data) even though unseasonably mild weather held down outlays for heating. While retail sales had slowed recently, the latest surveys indicated that consumer sentiment had risen further from an already markedly high level.

Housing activity in March and April was in line with that in other recent months. Single-family housing starts were unchanged in April after having declined in March. Starts for the two-month period were only a little below the average for 1996, and sales of new homes remained at a very high level in March (latest data). Multifamily starts rose considerably in April and on average over March and April were a little above the elevated level in the fourth quarter.

Business fixed investment expanded briskly in the first quarter. Outlays for producers' durable equipment rebounded after fourth-quarter weakness, and spending for nonresidential structures posted another substantial advance. Available indicators pointed to further sizable gains in spending on both equipment and structures. Business inventory investment was up considerably in the first quarter after having increased a relatively small amount in the fourth quarter; however, inventory–sales ratios for most industry and trade groupings remained at very low levels.

The nominal deficit on U.S. trade in goods and services widened substantially on balance over January and February from the temporarily depressed rate in the fourth quarter of last year and was about the same as the rate in the third quarter. A surge in imports reflected a rebound in the importation of automotive products from the strike-reduced level of the fourth quarter, further expansion in purchases of imported computers, and an upturn in imports of semiconductors after four quarters of declines. By contrast, exports of goods and services rose only slightly in the January–February period; exports of automotive products were up sharply, but sizable increases in exports of chemicals, computers, and semiconductors were largely offset by declines in other nonautomotive trade categories. Recent economic information on the foreign G-7 countries, including some preliminary indicators for the second quarter, suggested that the growth of output had strengthened somewhat on average in these countries. Activity in continental Europe, though still weak, was improving, while the economies of Canada, Japan, and the United Kingdom remained strong. Economic activity continued to expand rapidly on average in the major developing countries in the first quarter.

Recent data indicated that price inflation remained moderate despite a gradual acceleration of labor costs. Increases in consumer prices were held down in March and April by sizable declines in energy prices and a small net reduction in food prices. Consumer prices for items other than food and energy advanced at a moderate rate over the two months, and over the twelve months ended in April they increased the same amount as in the previous twelve months. Producer prices fell in both March and April, reflecting large declines in energy prices. Excluding food and energy, producer prices edged lower in April after having risen a sizable amount in March. Core producer prices increased considerably less over the twelve months ended in April than over the previous twelve months. At earlier stages of production, producer prices registered declines both in recent months and for the twelve months ended in April. An upward creep in the growth of labor costs was apparent in data on the hourly compensation of private industry workers; although the rise in the first three months of 1997 was smaller than the increase in the fourth quarter, the advance over the twelve months ended in March was larger than that over the previous twelve months. A similar but more pronounced pattern was evident in data on average hourly earnings for production or nonsupervisory workers.

At its meeting on March 25, 1997, the Committee issued a directive that called for a slight increase in the degree of pressure on reserve positions; the firming of policy was taken in light of continued rapid growth of aggregate demand in the first quarter and the attendant greater risk of heightened pressures on resources and an upturn in inflation. Although further policy tightening might be needed at some point, the Committee did not believe that developments during the intermeeting period were likely to require an adjustment, and thus the directive did not include a presumption about adjustments to policy during the intermeeting period. The reserve conditions associated with this directive were expected to be consistent with some moderation in the expansion of M2 and M3 over coming months.

Open market operations immediately after the meeting on March 25 were directed toward implementing the slightly firmer reserve conditions desired by the Committee and then maintaining those conditions over the remainder of the intermeeting period. The federal funds rate averaged close to the higher intended level of 5½ percent. Open market operations were complicated during the period by extraordinarily large federal tax payments in April, which substantially increased the volume of open market purchases needed to offset the reserve drains associated with those tax payments.

Market interest rates generally posted small mixed changes over the intermeeting period. Most private short-term rates increased only a little in response to the March policy action, which had been largely anticipated by market participants. Intermediate- and long-term yields rose over the early part of the intermeeting period, responding mostly to incoming data suggesting that growth in aggregate demand and output remained strong; these increases were subsequently more than reversed, however, as later information indicated that economic growth was moderating and price inflation remained subdued and on news of an agreement to balance the federal budget. Major indexes of stock market prices fluctuated substantially over the period but they rose considerably on balance.

In foreign exchange markets, the trade-weighted value of the dollar in terms of the other G-10 currencies declined on balance over the intermeeting period. The movements of the dollar during the period roughly corresponded to the fluctuations in intermediate- and long-term U.S. interest rates; the dollar advanced strongly in April on growing expectations of a further firming of U.S. monetary policy but more than retraced that gain in May as the likelihood of further tightening waned. The dollar's weakness in May also seemed to reflect growing attention to the prospects for official intervention to restrain the dollar's rise, notably against the Japanese yen and the German mark.

The growth of M2 and M3 remained brisk over March and April. Much of M2's strength during this period resulted from a temporary buildup by households of balances in savings accounts and money market mutual funds to cover unusually large tax payments. The rapid growth of M3 was associated not only with the bulge in M2 but also with stepped-up issuance of large time deposits to fund the expansion of bank credit. For the year through April, both aggregates expanded at rates appreciably above the upper bounds of their respective ranges for the year. The growth of total domestic nonfinancial debt had moderated over recent months as a result of reductions in federal government borrowing.

The staff forecast prepared for this meeting suggested that the economy would expand in the second half of the year at a rate a little above that of its estimated potential and then would increase at a slower and more sustainable rate in 1998. Growth of consumer spending, supported by high levels of household wealth and further projected gains in employment and income, was expected to remain fairly brisk over the forecast horizon. Business spending on equipment and structures was anticipated to continue to outpace the overall expansion of the economy, though the differential would tend to narrow over time in conjunction with the gradual diminution of increases in sales and profits that was expected to be associated with moderating economic growth. Housing construction was projected to drift lower over coming quarters, partly in conjunction with the rise in mortgage interest rates that already had occurred but also in response to the smaller increases expected in household income. The staff continued to anticipate that fiscal policy and the external sector would exert mild restraint on the expansion of economic activity. With resource utilization high and labor compensation gradually accelerating, core consumer price inflation was forecast to drift slightly higher.

In the Committee's discussion, the members agreed that the information for recent months pointed on balance to a marked slowing in the expansion of economic activity from a very rapid pace in late 1996 and earlier this year. The extent of the reduced growth in the current quarter and the prospects for subsequent quarters were subject to substantial uncertainty, but the members generally felt that the economy retained considerable underlying strength. In the circumstances and assuming no changes from current financial conditions, the individual members saw likely prospects for expansion over the forecast horizon at a pace close to, or a little above, the estimated growth of the economy's long-run potential. Many noted, however, that high levels of consumer and business confidence and supportive financial conditions among other factors suggested the possibility that growth could turn out to be even faster. With the utilization of productive resources, notably labor, already at particularly high levels in relation to the economy's potential, an outcome no stronger than current forecasts could well have adverse implications for inflation. Nonetheless, the members also noted that the rise in compensation increases had been damped and that there continued to be few indications of accelerating price inflation in the statistical and anecdotal information available at this time; such developments underlined persisting uncertainties about behavior in labor markets and the level and growth of the economy's sustainable potential.

In their review of developments in key sectors of the economy, members referred to favorable underlying factors in the outlook for consumer spending. These included solid growth in consumer incomes, large increases in financial wealth, and currently high levels of consumer confidence. While more moderate growth in consumer spending for durable goods seemed likely after an extended period of robust expansion, these favorable factors suggested that the risks of a different outcome were tilted in the direction of faster-than-projected expansion. On the negative side, large consumer debts were still viewed as likely to constitute an inhibiting influence on consumer expenditures, and many banking institutions had tightened lending terms and conditions at least for their more marginal consumer borrowers. On balance, growth in consumer expenditures at a somewhat reduced pace approximating that of the expected expansion of disposable incomes appeared to be a reasonable prospect, though one that was subject to considerable uncertainty.

Spending for business fixed investment seemed to have retained a good deal of momentum even after the large increases in such expenditures in recent years. Clearly, businesses regarded such investments as highly profitable, and they appeared to be leading to gains in productivity that in turn were helping to offset rising compensation and to maintain profit margins in highly competitive markets. In the circumstances, it appeared unlikely that growth in capital outlays would moderate appreciably for some time. A number of members also referred to the increasing strength in nonresidential construction, notably that of commercial structures, in several parts of the nation. Some referred in particular to planned or actual construction of new office buildings in various locales; such activity was being stimulated by declining vacancy rates, rising rents, and a ready availability of financing. Likewise, a surge in tourism in a number of areas had resulted in a scarcity of hotel rooms and was spurring hotel construction in some major cities. Anecdotal reports of nonresidential building activity undertaken on a speculative basis had increased, but a building boom reminiscent of the 1980s did not appear to be under way.

Concerning the outlook for housing, members referred to forecasts of a mild downtrend in residential construction associated with the increases that had occurred in mortgage interest rates. To date, however, there were few indications of any weakening. Indeed, housing construction had been relatively robust in the early months of the year, though the strength probably was largely accounted for by unusually favorable weather conditions and may have borrowed from building activity later in the year. On balance, as evidenced by anecdotal reports from some areas, various factors including ongoing growth in employment and incomes, the availability of financing on still generally favorable terms, and the associated affordability of housing for many homeowners seemed likely to provide continued support for this sector of the economy for some period of time.

A surge in nonfarm business inventory investment accounted for a substantial portion of the acceleration in output in the first quarter, and an anticipated moderation in the accumulation of inventories was an important element in forecasts of greatly reduced economic growth in the current quarter. In keeping with business practices aimed at achieving or maintaining lean inventory–sales ratios, inventory investment was projected to continue at a relatively subdued pace in coming quarters. A number of members expressed the view, however, that stockbuilding represented an upside risk in the economic outlook, at least in the nearer term. While there were some indications of efforts to pare inventories in recent months, generally optimistic business sentiment and currently trim inventories in most industries might well foster efforts to accumulate stocks at a relatively rapid pace, especially if more-buoyant-than-anticipated sales were to stimulate a precautionary demand for inventories as had occurred in 1994.

With regard to the outlook for inflation, members observed that increases in prices had remained subdued despite the rapid expansion in economic activity in recent quarters and the associated increase in pressures on already highly utilized resources. The appreciation of the dollar undoubtedly had helped to damp domestic inflation this year, and reported increases in consumer prices also had been held down to a marginal extent by an ongoing series of technical adjustments to the consumer price index. These were only partial explanations, however, and the members found it very difficult to account for the surprisingly benign behavior of inflation in an economy that had been operating at a level approximating full employment—indeed, possibly somewhat above sustainable full employment in labor markets in the view of a number of members, especially taking into consideration the recent further decline in the unemployment rate. On the basis of historical patterns, any overshooting of full employment would be expected to generate rising inflation over time. Although increases in labor compensation had been trending higher, these pressures were muted and had not shown through to prices.

Members focused on the possible role of faster-than-reported increases in productivity as a key explanation for the benign behavior of inflation in current circumstances. Business firms had continued to report robust profit margins in a period when competitive pressures generally prevented them from raising their prices, or raising them sufficiently, to pass on the increases that they were experiencing in worker compensation. Standard statistical measures that pointed to relatively limited increases in productivity seemed inconsistent with strong profits as well as with anecdotal reports of sizable gains associated with widespread business restructuring activities and large additions of high-technology equipment to an increasingly efficient capital stock. The ongoing development and spreading adoption of automated equipment along with the increasing skills and other infrastructure needed to use it effectively appeared to be creating growing efficiencies or synergies that were markedly enhancing productivity and enabling firms to hold the line on prices and maintain high profit margins.

While these were welcome developments, members continued to express concern that, perhaps sooner rather than later, growing pressures on productive resources would be reflected in some upturn in overall inflation. Although most measures of labor compensation had been relatively favorable recently, such measures had been displaying a clear uptrend over a somewhat longer period, and it seemed likely that, if this trend continued, labor cost developments would at some point be reflected more fully in core measures of prices. Members commented that the timing and extent of any upturn in price inflation would depend on growth of overall demand in the economy, but they also believed that expansion of demand in line with their current expectations could induce a somewhat less favorable inflation experience during coming quarters. However, recent developments had underscored the fact that historical experience was not a fully reliable guide to the prospective behavior of prices; accordingly, the inflation outlook remained subject to considerable uncertainty.

In the Committee's discussion of policy for the intermeeting period ahead, all but one of the members indicated that they could support a proposal to maintain an unchanged policy stance, although some also expressed a preference for some tightening at this meeting. Those who endorsed a steady policy at this time agreed that some tightening might well be needed later to contain potentially rising inflation. For now, however, economic growth seemed to be slowing to a more sustainable pace, and the uncertainties surrounding the extent of the slowing and the outlook for inflation pointed to the desirability of a cautious approach to any policy tightening, especially given the persisting absence of a rising inflation trend in current measures of prices. A number of members also observed that real interest rates were not unusually low. Thus, the present stance of monetary policy probably was not very far out of alignment with what likely would prove to be a desirable degree of restraint, thereby lessening any risk of large and persisting imbalances that a delay in implementing further restraint might incur.

Members who preferred some tightening, at least in the near term if not necessarily at this meeting, noted that the Committee needed to weigh the risks of having to implement a small degree of restraint now versus considerably more later if inflation were allowed to build momentum. Monetary policy exerts its effects with a considerable lag, and a small but relatively prompt tightening action would provide some further insurance against an intensification of inflation. Such an outcome could be seen as more likely now, given the increased tightness in labor markets and the possibility that relatively strong growth would put added pressures on resources. Some of these members commented that the risk of a retarding effect on the economy from a small move at this time was quite limited in light of the apparently solid momentum of the economic expansion. Indeed, the strength of investment demand, the ready availability of financing, and possible favorable productivity gains argued that real rates of interest would need to be higher than historical norms to balance aggregate demand and supply. The risk of slightly lower economic growth needed to be compared with what they viewed as the greater risk of losing ground to inflation and thereby inhibiting the Committee's ability to reach its ultimate goal of price stability, a goal that all the members viewed as necessary to achieve maximum sustainable economic growth over time. Given the quiescence of inflation and the uncertainties surrounding its outlook, however, all but one of these members could accept a wait-and-see policy stance for now.

With regard to possible adjustments to policy during the intermeeting period, all the members supported a shift from the symmetric directive that had been adopted in conjunction with the policy tightening action at the March meeting to an asymmetric directive tilted toward tightening. While such a bias did not necessarily imply an intention to tighten policy during the weeks immediately ahead, it was consistent with the members' view that the risks were in the direction of a potential need for some tightening in monetary policy to counter rising inflationary pressures, and that they might be required to make such a decision in the not-too-distant future.

At the conclusion of the Committee's discussion, all but one member indicated that they supported a directive that called for maintaining the existing degree of pressure on reserve positions and that included a bias toward the possible firming of reserve conditions during the intermeeting period. Accordingly, in the context of the Committee's long-run objectives for price stability and sustainable economic growth, and giving careful consideration to economic, financial, and monetary developments, the Committee decided that somewhat greater reserve restraint would be acceptable and slightly lesser reserve restraint might be acceptable during the intermeeting period. The reserve conditions contemplated at this meeting were expected to be consistent with moderate growth of M2 and M3 over coming months.

The Federal Reserve Bank of New York was authorized and directed, until instructed otherwise by the Committee, to execute transactions in the System Account in accordance with the following domestic policy directive:

The information reviewed at this meeting suggests that growth in economic activity has slowed after surging in late 1996 and earlier this year. Private nonfarm payroll employment increased at a considerably reduced pace over March and April, but the civilian unemployment rate fell appreciably to 4.9 percent in April. Industrial production was flat in April following sizable gains over previous months. Nominal retail sales were unchanged in March and declined in April after a considerable advance in earlier months. Housing activity in March and April was little changed from other recent months. Available indicators point to further sizable gains in business fixed investment. The nominal deficit on U.S. trade in goods and services widened substantially in January–February from its temporarily depressed rate in the fourth quarter. Underlying price inflation has remained subdued.

Market interest rates generally have posted small mixed changes since the Committee meeting on March 25, 1997; share prices in equity markets have risen considerably. In foreign exchange markets, the trade-weighted value of the dollar in terms of the other G-10 currencies declined on balance over the intermeeting period.

Growth of M2 and M3 was brisk over March and April, boosted by a buildup in household balances to cover unusually large tax payments. For the year through April, both aggregates expanded at rates appreciably above the upper bounds of their respective ranges for the year. Growth in total domestic nonfinancial debt has moderated over recent months, reflecting reductions in federal government borrowing.

The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. In furtherance of these objectives, the Committee at its meeting in February established ranges for growth of M2 and M3 of 1 to 5 percent and 2 to 6 percent respectively, measured from the fourth quarter of 1996 to the fourth quarter of 1997. The monitoring range for growth of total domestic nonfinancial debt was set at 3 to 7 percent for the year. The behavior of the monetary aggregates will continue to be evaluated in the light of progress toward price level stability, movements in their velocities, and developments in the economy and financial markets.

In the implementation of policy for the immediate future, the Committee seeks to maintain the existing degree of pressure on reserve positions. In the context of the Committee's long-run objectives for price stability and sustainable economic growth, and giving careful consideration to economic, financial, and monetary developments, somewhat greater reserve restraint would or slightly lesser reserve restraint might be acceptable in the intermeeting period. The contemplated reserve conditions are expected to be consistent with some moderation in the expansion of M2 and M3 over coming months.

Votes for this action: Messrs. Greenspan, McDonough, Guynn, Kelley, Meyer, Moskow, Parry, Mses. Phillips and Rivlin. Vote against this action: Mr. Broaddus.

Mr. Broaddus dissented because he believed that the strength of investment demand, due possibly to an increase in the trend growth rate of productivity, required somewhat higher real interest rates to prevent inflationary pressures from developing. He was concerned that, with the economy already operating at a high level and labor markets apparently very tight, any increase in such pressures might be costly to reverse and might reduce the credibility of the Committee's longer-run strategy of promoting maximum sustainable growth by fostering price level stability. He also believed that the risk to the economy of a moderate further tightening was small given the apparent momentum of aggregate economic activity.

It was agreed that the next meeting of the Committee would be held on Tuesday–Wednesday, July 1–2, 1997.

The meeting adjourned at 12:45 p.m.

Donald L. Kohn
Secretary

Meeting Held on July 1–2, 1997

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Tuesday, July 1, 1997, at 2:30 p.m. and continued on Wednesday, July 2, 1997, at 9:00 a.m.

Present:

Mr. Greenspan, Chairman
Mr. McDonough, Vice Chairman
Mr. Broaddus
Mr. Guynn
Mr. Kelley
Mr. Moskow
Mr. Meyer
Mr. Parry
Ms. Phillips
Ms. Rivlin

Messrs. Hoenig, Jordan, Melzer, and Ms. Minehan, Alternate Members of the Federal Open Market Committee

Messrs. Boehne, McTeer, and Stern, Presidents of the Federal Reserve Banks of Philadelphia, Dallas, and Minneapolis respectively

Mr. Kohn, Secretary and Economist
Mr. Bernard, Deputy Secretary
Mr. Coyne, Assistant Secretary
Mr. Gillum, Assistant Secretary
Mr. Mattingly, General Counsel
Mr. Baxter, Deputy General Counsel
Mr. Prell, Economist
Mr. Truman, Economist

Messrs. Beebe, Goodfriend, Hunter, Lindsey, Mishkin, Promisel, Siegman, Slifman, and Stockton, Associate Economists

Mr. Fisher, Manager, System Open Market Account

Mr. Ettin, Deputy Director, Division of Research and Statistics, Board of Governors
Messrs. Madigan and Simpson, Associate Directors, Divisions of Monetary Affairs and Research and Statistics respectively, Board of Governors
Ms. Johnson, Assistant Director, Division of International Finance, Board of Governors

Messrs. Reifschneider[4] and Small,[4] Section Chiefs, Divisions of Research and Statistics and Monetary Affairs respectively, Board of Governors

Mr. Sichel, Senior Economist, Division of Research and Statistics, Board of Governors

Mr. Elmendorf,[4] and Ms. Garrett, Economists, Division of Monetary Affairs, Board of Governors

Mr. Lebow,[5] and Ms. Lindner,[5] Economists, Division of Research and Statistics, Board of Governors

Ms. Low, Open Market Secretariat Assistant, Division of Monetary Affairs, Board of Governors

4. Attended portions of meeting relating to the Committee's review of the economic outlook and establishment of its monetary and debt ranges for 1998.

5. Attended portion of meeting relating to price measurement issues for monetary policy.

Ms. Holcomb, First Vice President, Federal Reserve Bank of Dallas

Ms. Browne, Messrs. Dewald, Hakkio, Kos, Lang, Rolnick, Rosenblum, and Sniderman, Senior Vice Presidents, Federal Reserve Banks of Boston, St. Louis, Kansas City, New York, Philadelphia, Minneapolis, Dallas, and Cleveland respectively

Ms. Rosenbaum, Vice President, Federal Reserve Bank of Atlanta

By unanimous vote, the minutes of the meeting of the Federal Open Market Committee held on May 20, 1997, were approved.

The Manager of the System Open Market Account reported on developments in foreign exchange markets since the meeting on May 20, 1997. There were no System open market transactions in foreign currencies during this period, and thus no vote was required of the Committee.

The Manager also reported on developments in domestic financial markets and on System open market transactions in government securities and federal agency obligations during the period May 20, 1997, through June 30, 1997. By unanimous vote, the Committee ratified these transactions.

The Committee then turned to a discussion of the economic outlook, the ranges for the growth of money and debt in 1997 and 1998, and the implementation of monetary policy over the intermeeting period ahead. A summary of the economic and financial information available at the time of the meeting and of the Committee's discussion is provided below, followed by the domestic policy directive that was approved by the Committee and issued to the Federal Reserve Bank of New York.

The information reviewed at this meeting suggested that the economic expansion slowed substantially in the second quarter after having surged in late 1996 and earlier this year. Consumer spending decelerated considerably, but business spending on durable equipment increased substantially further and housing demand appeared to have been well maintained. Employment growth moderated recently, while industrial production continued to rise appreciably. Price inflation remained subdued despite high rates of resource utilization, notably that of labor.

Private nonfarm payroll employment rose at a reduced pace in May after having registered sizable advances over the first four months of the year. Job growth remained brisk in the services sector despite a further drop in employment at temporary help agencies that might have reflected constraints on the availability of workers for hire. Although employment in construction recovered in May from the weather-depressed level in April, the underlying growth in such jobs seemed to have slowed. Employment in manufacturing changed little over April and May after having increased moderately in the first quarter. The average workweek for production or nonsupervisory workers was unchanged in May but was slightly below the average for the first quarter. The civilian unemployment rate fell slightly further to 4.8 percent in May.

Industrial production continued to grow briskly in May. Manufacturing output recorded a substantial gain and mining production rose considerably; however, cooler-than-average weather led to a drop in utility output. Much of the rise in manufacturing reflected a rebound in the production of motor vehicles and parts from strike-depressed levels in April and strength in the output of business equipment, construction supplies, and materials. With output generally keeping pace with the rapid expansion of factory capacity, the rate of utilization of manufacturing capacity remained at a relatively high level.

Personal consumption expenditures, in real terms, rose substantially in May after having changed little on balance over the preceding three months. Spending on services remained on a solid uptrend in May, while aggregate purchases of goods turned up after three months of lackluster spending on nondurable goods and motor vehicles. The unusual weather patterns of late winter and early spring apparently had a depressing effect on consumer expenditures, especially for seasonal items; however, the combination of strong job gains, buoyant sentiment, and increased household net worth pointed to a possible resumption of more robust spending by consumers.

Housing activity appeared to have been generally well maintained in recent months. Although housing starts were down somewhat in May from the relatively elevated average rate for the first four months of the year, this slowing might have been, at least in part, the result of unusually mild winter weather that enabled an early start on spring building activity. The latest information on home sales suggested continued firm demand for single-family housing: Sales of existing homes rose in May and were among the highest monthly totals on record, and sales of new homes in April (latest data available) were down only a little from the brisk pace of earlier months in the year.

Available information suggested further sizable gains in business fixed investment. Shipments of nondefense capital goods edged higher in May after having posted large increases in earlier months of the year. Shipments of computers had been particularly strong this year in conjunction with rapidly falling prices, but shipments of other categories of capital goods also had been robust on balance. Recent data on orders pointed to further brisk growth in coming months. Nonresidential construction activity appeared to have eased recently, with construction-put-in-place slipping in March and April from the elevated pace of the first two months of the year. However, other information suggested that the downturn might be shortlived: Vacancy rates for office space had been declining, prices for commercial real estate had been edging up, and recent data on contracts suggested that building activity would improve in coming months.

Business inventory investment picked up sharply in April from the slow pace in March but, overall, stocks remained at a low level in relation to sales. In manufacturing, much of the increase in stocks occurred in capital goods industries in which production was expanding briskly. In the wholesale sector, a substantial decline in stocks in April more than offset a sizable increase in March, and the aggregate stock–sales ratio for the sector fell further over the March–April period. Retail inventories rose considerably in April, with notable increases in stocks of apparel and general merchandise. In a departure from the general downtrend of recent months, inventory–sales ratios for most types of retail establishments were up appreciably in April.

The nominal deficit on U.S. trade in goods and services narrowed somewhat in April from a downward-revised average rate in the first quarter. The value of exports in April rose substantially from the first-quarter level, led by increases in exports of machinery and aircraft. The value of imports also rose but less than that of exports; imports were up in most trade categories except petroleum products. Recent information suggested that, on average, economic activity in the major foreign industrial countries continued to grow at a moderate rate in the second quarter. Growth remained robust in Canada and the United Kingdom and was improving in Germany, France, and Italy. Economic activity appeared to have flattened temporarily in Japan after an increase in the consumption tax in April.

Price inflation remained subdued. For a third straight month, consumer prices recorded only a slight increase in May. Favorable developments in food and energy continued to hold down the overall rise and accounted for a much smaller advance in the index of prices of all consumer items over the twelve months ended in May than over the previous twelve months. The decline in core CPI inflation over the same time period was much less, though this measure of inflation also remained relatively restrained. At the producer level, prices of finished goods other than food and energy fell further in May and were little changed over the year ended that month. At earlier stages of processing, producer prices for intermediate materials other than food and energy changed little over the year ended in May, and producer prices at the crude level advanced only slightly. The tight conditions prevailing in labor markets were associated with a somewhat larger increase in average hourly earnings in the twelve months ended in May than in the year-earlier period.

At its meeting on May 20, 1997, the Committee adopted a directive that called for maintaining the existing degree of pressure on reserve positions. Because the members saw the potential need for some tightening in monetary policy to counter rising inflationary pressures, perhaps in the relatively near term, the directive included a bias toward the possible firming of reserve conditions during the intermeeting period. The reserve conditions associated with this directive were expected to be consistent with moderate growth of M2 and M3 over coming months.

Open market operations were directed throughout the intermeeting period toward maintaining the existing degree of pressure on reserve positions, and the federal funds rate averaged close to the intended level of 5½ percent. Most other market interest rates declined somewhat on balance during the period. Market participants apparently concluded that the likelihood of further policy tightening had decreased substantially in light of incoming data that suggested slowing growth of final demand and continued subdued inflation. Share prices in equity markets rose considerably further.

In foreign exchange markets, the trade-weighted value of the dollar in terms of the other G-10 currencies was up on balance over the intermeeting period; the advance occurred despite a smaller decline on average in long-term interest rates abroad than in the United States. The dollar rose appreciably against the German mark and most other continental European currencies amid growing market concerns that there would be broad participation in the European Monetary Union despite the fact that the major European countries would not be able to comply strictly with the Maastricht fiscal standards and related expectations that the euro would be a weak currency. In contrast, the dollar fell against the Japanese yen and the British pound; the yen moved up as markets focused more closely on recent and prospective increases in Japan's current account surplus, and the pound strengthened in anticipation of further policy tightening by the Bank of England.

Expansion of M2 and M3 slowed sharply in May in association with a swing in household balances related to large tax payments; growth of M2 rebounded in June, but M3 accelerated less. For the year through June, M2 increased at a rate near the upper bound of its range for the year. Rapid growth of M3 over the first half of the year, partly in conjunction with robust expansion of bank credit, placed growth of this aggregate somewhat above the upper bound of its range. The rate of increase in total domestic nonfinancial debt had been a little higher in recent months; for the year to date, this aggregate had grown at a rate near the middle of its range.

The staff forecast prepared for this meeting suggested that the economy would expand at a pace somewhat above that of its estimated potential in the second half of the year but would slow to a rate of increase more in line with that of potential in 1998. Growth of consumer spending, supported by high levels of household wealth and further projected gains in employment and income, was expected to be relatively brisk for some time. Business spending on equipment and structures was anticipated to continue outpacing the overall expansion of the economy, though the differential would tend to narrow in association with the gradual diminution of increases in sales and profits that was expected to occur in the context of moderating economic growth. Housing construction was projected to drift lower over the forecast period. The staff anticipated that fiscal policy and the external sector would exert mild restraint on the expansion of economic activity. With labor compensation gradually accelerating in the context of high resource utilization, core consumer price inflation was forecast to drift slightly higher.

In the Committee's discussion of current and prospective economic developments, members commented on the continuing exceptional performance of the economy, including widespread indications of strength in business activity and subdued inflation. After a surge in late 1996 and earlier this year, the rate of expansion had moderated considerably in recent months, and the members generally expected economic activity to settle into a pattern of growth over the next six quarters that would approximate the economy's estimated output potential. A major factor in that outlook was their expectation of some deceleration in demands for consumer durables and business plant and equipment in light of the substantial buildup of such assets that already had taken place in recent years. However, given the underlying strength of the expansion, favorable financial conditions, and the absence of major imbalances in the economy, the risks of a different outcome were judged to be in the direction of somewhat faster growth than currently projected. The outlook for inflation was subject to particular uncertainty. Despite an economy that had been operating for a considerable period at rates of resource utilization that were very close to, and by some estimates somewhat above, sustainable levels, inflation had remained relatively low and indeed had declined on the basis of some broad measures of prices. Such an outcome was very much welcome, but the reasons for it were not completely understood and appeared to include some factors that might exert only temporary restraint on price increases. Consequently, continuing pressures on resources associated with economic growth in line with the members' current forecasts could well be reflected in rising inflation over time.

In keeping with the practice at meetings when the Committee sets its long-run ranges for the money and debt aggregates, the members of the Committee and the Federal Reserve Bank presidents not currently serving as members provided individual projections of the growth in real and nominal GDP, the rate of unemployment, and the rate of inflation for the years 1997 and 1998. The forecasts of the rate of expansion in real GDP for 1997 as a whole had a central tendency of 3 to 3¼ percent and for 1998 were centered on a range of 2 to 2½ percent. With regard to the growth of nominal GDP, most of the forecasts were in ranges of 5 to 5½ percent for 1997 and 4½ to 5 percent for 1998. The civilian rate of unemployment associated with these forecasts had a central tendency of 4¾ to 5 percent in the fourth quarters of both years. Projections of the rate of inflation, as measured by the consumer price index, pointed to a sizable moderation this year from the rate in 1996 and a partially offsetting rise in 1998, with prices of food and energy accounting for much of the swing. Specifically, the projections converged on CPI inflation rates of 2¼ to 2½ percent in 1997 and 2½ to 3 percent in 1998.

In their review of the outlook for economic activity in major sectors of the economy, members referred to the generally sluggish pace of retail sales in recent months. It was noted, however, that the slowdown was perhaps in part an adjustment to very strong growth of sales in previous months, and some members commented on anecdotal indications of some pickup in recent weeks. More importantly, underlying trends and fundamentals pointed to prospective growth in consumer expenditures at a pace that was likely to continue to provide key support for further moderate expansion in overall economic activity. In particular, jobs and incomes had continued to post sizable gains; further large increases in stock market prices had raised wealth-to-income ratios sharply; and consumer optimism had risen to new highs. On the other hand, the accumulation of consumer durables that had occurred over the course of the current cyclical advance was likely to exert a retarding influence on the rise in consumer spending. Other somewhat restraining factors included the prospect of some softening in housing demand and related purchases of household goods and the already heavy debt repayment burdens of many consumers. Some members also noted that a possible correction from the currently elevated levels of stock market prices could have adverse effects on consumer sentiment and purchasing power. On balance, growth in personal consumer expenditures was seen as likely to approximate the moderate rate of increase projected in overall domestic demand.

The members viewed the prospects for further growth in business fixed investment as another important supportive factor in the outlook for sustained economic expansion. Current indicators pointed to the continuation of very rapid growth in such spending over the near term, but some moderation was likely over the course of coming quarters in conjunction with the projected slowing in the increase of overall demand and the very large buildup in the stock of capital that already had occurred in recent years. Even so, investment spending was likely to be relatively robust over the projection horizon in the context of continuing incentives to hold down production costs in highly competitive markets and to take advantage of falling prices and wider applications for certain types of new equipment, notably computer-related equipment. The ready availability of both debt and equity finance on favorable terms, an upbeat outlook for sales in many industries, and generally high profit levels were other positive factors. The outlook for nonresidential construction activity also seemed to be relatively favorable. Members referred to declining vacancy rates and rising rents for commercial structures in many parts of the country and noted that construction contracts for new office buildings and hotels recently had turned up on a nationwide basis after a pause earlier this year. In sum, the growth in business fixed investment seemed likely to continue to outpace that of overall demand in coming quarters.

Some restraint on aggregate demand would come from other sectors of the economy—notably government spending, net exports, housing, and perhaps business inventories. None of these factors seemed likely to exert a substantially negative effect, but in total they were expected to help keep the pace of the expansion close to the estimated rate of increase in the economy's potential over coming quarters.

During the course of the Committee's discussion, many of the members commented on the persistence of an impressively benign inflation performance despite widespread indications of very high, and by some measures increasing, levels of capacity use. Indeed, most broad measures of prices pointed to subdued or even declining inflation, and it was difficult to find evidence of rising inflation pressures in "pipeline" price data or the wage structure. The members anticipated that inflation as measured by the consumer price index would decrease appreciably over 1997 as a result of favorable developments in the food and especially the energy sectors of the economy and declining import prices associated with the previous appreciation of the dollar. These positive influences would wane over time, however, and consumer prices were likely to rise at a somewhat faster pace in 1998.

The members agreed that the risks to their price forecasts were in the direction of higher inflation, given already high levels of capacity use and their expectations of appreciable further economic growth. Nonetheless, the relatively low inflation experienced despite a lengthy period of fully employed resources suggested that the timing of a potential upturn in inflation—indeed whether inflation would in fact pick up—could not be predicted with any degree of confidence on the basis of past historical patterns. The reasons for the persistence of a relatively benign inflation performance in the current expansion were not fully understood. They included some temporary factors such as the effect of the rise in the dollar on import prices and the restraint on health care costs. More fundamentally, they presumably also involved the favorable effects on production costs of widespread business restructurings and the large volume of investment in more productive technology in recent years, the impact of both factors on the job security concerns of workers and their willingness to accept reduced increases in compensation, and the effects of an intense degree of competition among domestic and foreign producers in U.S. markets. With regard to the possibility that more robust productivity increases would be holding down production costs, it was noted that a surge in economic activity, such as had occurred in late 1996 and early 1997, tended to be accompanied by above-trend gains in productivity. A slower pace of economic growth in the second quarter and beyond might provide an opportunity to assess whether productivity increases were on a clear uptrend and could help to explain the favorable behavior of prices over an extended period. In any event, it was too early to reach any firm conclusion on this issue or the broader question of whether or when a rise in inflation might materialize under anticipated economic conditions.

The members also discussed a staff study of the relative performance of various price indexes as measures of inflation. Members noted that most broad measures of inflation moved together over extended periods of time, but they did not always do so over short intervals. Differences in construction, coverage, and other factors meant that none of the individual measures was clearly superior in assessing general inflation trends, and several members commented that all measures needed to be monitored.

In keeping with the requirements of the Full Employment and Balanced Growth Act of 1978 (the Humphrey–Hawkins Act), the Committee at this meeting reviewed the ranges for growth of the monetary and debt aggregates that it had established in February for 1997, and it decided on tentative ranges for those aggregates for 1998. The current ranges set in February for the period from the fourth quarter of 1996 to the fourth quarter of 1997 were unchanged from the ranges for 1996 and included expansion of 1 to 5 percent for M2 and 2 to 6 percent for M3. An unchanged range of 3 to 7 percent also was set in January for growth of total domestic nonfinancial debt in 1997.

All the members favored retaining the current ranges for this year and extending them on a provisional basis to 1998. They anticipated that growth of M2 probably would continue at rates in the upper part of its current range in both years and that of M3 at rates approximating or even slightly above the upper bound of its range, given the Committee's expectations for the performance of the economy and prices. The current ranges were not expected to be guides to money growth under anticipated conditions in the period ahead, but instead could be viewed as anchors or benchmarks for money growth that would be associated with approximate price stability and sustained economic growth, assuming behavior of velocity in line with historical experience. Accordingly, a reaffirmation of those ranges would underscore the Committee's commitment to a policy of achieving price stability over time, and in the view of at least some members, higher ranges could raise questions in this regard.

Over the past few years, in contrast to earlier in the 1990s, the behavior of the broad aggregates, especially that of M2, in relation to nominal GDP and short-term interest rates had displayed a pattern that was in line with historical norms before the 1990s. The members viewed this as an encouraging development in that it raised the possibility of giving more weight at some point to the performance of these aggregates as useful indicators in formulating monetary policy. However, the period of more predictable M2 and M3 behavior was still relatively brief, and such behavior had occurred at a time of generally settled conditions in financial markets and the overall economy. The prospective performance of these aggregates in periods of rapid changes in financial and economic conditions was still an open question, and in light of the uncertainties that were involved the members concluded that it would be premature to place increased reliance on them in the conduct of policy. Accordingly, the Committee decided that despite projected growth of M2 and M3 at rates in the vicinity of the upper limits of the current ranges, prevailing uncertainties made it desirable to retain those ranges as benchmarks for the achievement of price stability rather than to establish higher ranges that seemed more likely to capture expected outcomes. In the circumstances, any tendency for growth of the monetary aggregates to move outside the Committee's ranges would not in itself call for a policy adjustment but would continue to be interpreted in the context of a broad range of business and financial developments bearing on the prospective performance of the overall economy.

The Committee members were unanimously in favor of retaining the current range of 3 to 7 percent for growth of total domestic nonfinancial debt in 1997 and extending that range on a provisional basis to 1998. They took account of a staff projection indicating that growth of the debt aggregate was likely to slow somewhat from its pace in 1995 and 1996, reflecting a small reduction in the expansion of federal government debt. According to the staff projection, growth in the debt measure would be near the midpoint of the existing range over the period through 1998.

At the conclusion of this discussion, the Committee voted to reaffirm the ranges for growth of M2, M3, and total domestic nonfinancial debt that it had established in February for 1997. For the year 1998, the Committee approved provisional ranges for the three aggregates that were unchanged from the 1997 ranges. In keeping with its usual procedure under the Humphrey–Hawkins Act, the Committee would review its preliminary ranges for 1998 early next year, or sooner if interim conditions warranted, in light of their growth and velocity behavior and ongoing economic and financial developments. Accordingly, the Committee voted to incorporate the following statement regarding the 1997 and 1998 ranges in its domestic policy directive:

> The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. In furtherance of these objectives, the Committee reaffirmed at this meeting the ranges it had established in February for growth of M2 and M3 of 1 to 5 percent and 2 to 6 percent respectively, measured from the fourth quarter of 1996 to the fourth quarter of 1997. The range for growth of total domestic nonfinancial debt was maintained at 3 to 7 percent for the year. For 1998, the Committee agreed on tentative ranges for monetary growth, measured from the fourth quarter of 1997 to the fourth quarter of 1998, of 1 to 5 percent for M2 and 2 to 6 percent for M3. The Committee provisionally set the associated range for growth of total domestic nonfinancial debt at 3 to 7 percent for 1998. The behavior of the monetary aggregates will continue to be evaluated in the light of progress toward price level stability, movements in their velocities, and developments in the economy and financial markets.

> Votes for this action: Messrs. Greenspan, McDonough, Broaddus, Guynn, Kelley, Meyer, Moskow, Parry, Mses. Phillips and Rivlin. Votes against this action: None.

In the Committee's discussion of policy for the intermeeting period ahead, all the members favored or could support a proposal to maintain an unchanged policy stance, and they strongly supported the retention of a bias toward restraint. An unchanged policy seemed appropriate with inflation still quiescent and business activity projected to settle into a pattern of moderate growth broadly consistent with the economy's long-run output potential. While the members assessed risks surrounding such a forecast as decidedly tilted to the upside, the slowing of the expansion should keep resource utilization from rising substantially further, and this outlook together with the absence of significant early signs of rising inflationary pressures suggested the desirability of a cautious "wait and see" policy stance at this point. In the current uncertain environment, this would afford the Committee an opportunity to gauge the momentum of the expansion and the related degree of pressure on resources and prices. The risks of waiting appeared to be limited, given that the evidence at hand did not point to a step-up in inflation despite low unemployment and that the current stance of monetary policy did not seem to be overly accommodative, at least on the basis of some measures such as the level of real short-term interest rates. In these circumstances, any tendency for price pressures to mount was likely to emerge only gradually and to be reversible through a relatively limited policy adjustment. Some members commented, however, that in the absence of unanticipated weakness in the economy, some tightening of policy was likely to be needed in the relatively near future, and one expressed the view that a tightening action at this meeting seemed desirable to forestall or limit the risks of intensifying inflationary pressures. However, waiting was an acceptable alternative given the favorable economic news and the persisting uncertainties surrounding the relationship of output to prices.

In their discussion of possible adjustments to policy during the intermeeting period, all the members indicated that they wanted to retain the existing asymmetry toward restraint adopted at the May meeting. An asymmetric directive was consistent with their view that the risks clearly were in the direction of excessive demand pressures in the economy and an associated upward trend in inflation. Such a bias in the directive also would serve the purpose of signaling the Committee's ongoing commitment to curb inflation in the interest of fostering maximum sustainable economic growth and employment. The members agreed that the current environment called for careful monitoring of developments and for prompt action by the Committee if needed to counter rising inflation. Indeed, in the interest of fostering a continuation of sustainable growth of the economy, it would be desirable to tighten on the basis of early signs of potentially intensifying inflation and before higher inflation actually materialized.

At the conclusion of the Committee's discussion, all the members indicated that they could support a directive that called for maintaining the existing degree of pressure on reserve positions and that retained a bias toward the possible firming of reserve conditions during the intermeeting period. Accordingly, in the context of the Committee's long-run objectives for price stability and sustainable economic growth, and giving careful consideration to economic, financial, and monetary developments, the Committee decided that somewhat greater reserve restraint would be acceptable and slightly lesser reserve restraint might be acceptable during the intermeeting period. The reserve conditions contemplated at this meeting were expected to be consistent with moderate expansion in M2 and M3 over coming months.

The Federal Reserve Bank of New York was authorized and directed, until instructed otherwise by the Committee, to execute transactions in the System Account in accordance with the following domestic policy directive:

The information reviewed at this meeting suggests that the economic expansion slowed substantially in the second quarter after surging in late 1996 and earlier this year. Private nonfarm payroll employment increased at a reduced pace in May, but the civilian unemployment rate fell slightly further to 4.8 percent. Industrial production registered another sizable gain in May. Personal consumption expenditures, in real terms, rose substantially in May after having changed little over the preceding three months. Housing activity appears to have been well maintained in recent months. Available indicators point to further sizable gains in business fixed investment. The nominal deficit on U.S. trade in goods and services narrowed somewhat in April from its downward-revised average rate in the first quarter. Price inflation has remained subdued.

Market interest rates generally have declined somewhat since the day before the Committee meeting on May 20, 1997; share prices in equity markets have risen considerably further. In foreign exchange markets, the trade-weighted value of the dollar in terms of the other G-10 currencies was up slightly on balance over the intermeeting period.

Growth of M2 and M3 fluctuated sharply from April to May in association with a swing in household balances related to large tax payments; on balance, both aggregates expanded at a moderate pace over the two months, and available data pointed to further moderate growth in June. For the year through June, M2 expanded at a rate near the upper bound of its range for the year and M3 at a rate somewhat above the upper bound of its range. Total domestic nonfinancial debt has continued to expand in recent months and is near the middle of its range.

The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. In furtherance of these objectives, the Committee reaffirmed at this meeting the ranges it had established in February for growth of M2 and M3 of 1 to 5 percent and 2 to 6 percent respectively, measured from the fourth quarter of 1996 to the fourth quarter of 1997. The range for growth of total domestic nonfinancial debt was maintained at 3 to 7 percent for the year. For 1998, the Committee agreed on tentative ranges for monetary growth, measured from the fourth quarter of 1997 to the fourth quarter of 1998, of 1 to 5 percent for M2 and 2 to 6 percent for M3. The Committee provisionally set the associated range for growth of total domestic nonfinancial debt at 3 to 7 percent for 1998. The behavior of the monetary aggregates will continue to be evaluated in the light of progress toward price level stability, movements in their velocities, and developments in the economy and financial markets.

In the implementation of policy for the immediate future, the Committee seeks to maintain the existing degree of pressure on reserve positions. In the context of the Committee's long-run objectives for price stability and sustainable economic growth, and giving careful consideration to economic, financial, and monetary developments, somewhat greater reserve restraint would or slightly lesser reserve restraint might be acceptable in the intermeeting period. The contemplated reserve conditions are expected to be consistent with moderate growth in M2 and M3 over coming months.

Votes for this action: Messrs. Greenspan, McDonough, Broaddus, Guynn, Kelley, Meyer, Moskow, Parry, Mses. Phillips and Rivlin. Votes against this action: None.

It was agreed that the next meeting of the Committee would be held on Tuesday, August 19, 1997.

The meeting adjourned at 11:55 a.m. on July 2.

Donald L. Kohn
Secretary

Meeting Held on August 19, 1997

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Tuesday, August 19, 1997, at 9:00 a.m.

Present:

Mr. Greenspan, Chairman
Mr. McDonough, Vice Chairman
Mr. Broaddus
Mr. Guynn
Mr. Kelley
Mr. Moskow
Mr. Meyer
Mr. Parry
Ms. Phillips
Ms. Rivlin

Messrs. Hoenig, Jordan, Melzer, and Ms. Minehan, Alternate Members of the Federal Open Market Committee

Messrs. Boehne, McTeer, and Stern, Presidents of the Federal Reserve Banks of Philadelphia, Dallas, and Minneapolis respectively

Mr. Kohn, Secretary and Economist
Mr. Bernard, Deputy Secretary
Mr. Coyne, Assistant Secretary
Mr. Gillum, Assistant Secretary
Mr. Mattingly, General Counsel
Mr. Prell, Economist
Mr. Truman, Economist

Messrs. Beebe, Cecchetti, Goodfriend, Eisenbeis, Lindsey, Promisel, Siegman, Slifman, and Stockton, Associate Economists

Mr. Fisher, Manager, System Open Market Account

Mr. Ettin, Deputy Director, Division of Research and Statistics, Board of Governors

Messrs. Madigan and Simpson, Associate Directors, Divisions of Monetary Affairs and Research and Statistics respectively, Board of Governors

Ms. Low, Open Market Secretariat Assistant, Division of Monetary Affairs, Board of Governors

Ms. Strand, First Vice President, Federal Reserve Bank of Minneapolis

Messrs. Lang, Rolnick, Rosenblum, and Sniderman, Senior Vice Presidents, Federal Reserve Banks of Philadelphia, Minneapolis, Dallas, and Cleveland respectively

Messrs. Gavin, Kahn, and Ms. Perelmuter, Vice Presidents, Federal Reserve Banks of St. Louis, Kansas City, and New York respectively

Ms. Little and Mr. Sullivan, Assistant Vice Presidents, Federal Reserve Banks of Boston and Chicago respectively

By unanimous vote, the minutes of the meeting of the Federal Open Market Committee held on July 1–2, 1997, were approved.

By unanimous vote, the Committee elected Mr. Stephen G. Cecchetti of the Federal Reserve Bank of New York as Associate Economist to serve until the election of his successor at the first meeting of the Committee after December 31, 1997. It was understood that in the event of the discontinuance of his official connection with the Federal Reserve Bank of New York, he would cease to have any official connection with the Federal Open Market Committee.

The Manager of the System Open Market Account reported on developments in foreign exchange markets since the meeting in early July. There were no System open market transactions in foreign currencies during this period, and thus no vote was required of the Committee.

The Manager also reported on developments in domestic financial markets and on System open market transactions in government securities and federal agency obligations during the period July 2, 1997, through August 18, 1997. By unanimous vote, the Committee ratified these transactions.

The Committee then turned to a discussion of the economic outlook and the implementation of monetary policy over the intermeeting period ahead. A summary of the economic and financial information available at the time of the meeting and of the Committee's discussion is provided below, followed by the domestic policy directive that was approved by the Committee and issued to the Federal Reserve Bank of New York.

The information reviewed at this meeting suggested that economic activity was expanding moderately. Growth in consumer spending had picked up after having slowed sharply in early spring, business purchases of durable equipment were still on a strong upward trend, and housing demand seemed to have been well maintained. The overall rise in production had been held down recently by supply disruptions in the motor vehicles industry, but employment had continued to expand at a strong pace and the unemployment rate was at a low level. Increases in labor compensation had remained moderate even though labor markets were tight, and price inflation was still subdued.

Private nonfarm payroll employment rose sharply in July after a June increase that was below the average for earlier months of the year. The step-up in job growth in July reflected substantially larger job gains in business services, retail trade, and the finance, insurance, and real estate industries. A small decline in manufacturing jobs roughly offset slightly higher employment in construction. The civilian unemployment rate, at 4.8 percent in July, matched its low for the current economic expansion.

Industrial production increased relatively slowly in July after having advanced at a fairly brisk pace over the first half of the year. The July slowdown reflected a temporary drop in motor vehicle assemblies partly associated with work stoppages at a major automotive manufacturer. Outside the motor vehicles sector, the output of business equipment and consumer durable goods rose strongly while the production of consumer nondurables weakened further. Factory capacity increased a little more than production in July, and the utilization of total manufacturing capacity slipped to its lowest level since last autumn.

Retail sales rose briskly in June and July after having changed little over the preceding three months. Sales at automotive dealers rebounded in June and July following substantial weakness in earlier months, and expenditures at nondurable goods stores also strengthened. By contrast, sales at non-automotive durable goods outlets were unchanged over June and July. The pickup in consumer spending occurred against a backdrop of further strong gains in incomes and household net worth. In addition, credit was readily available to most consumers, although lenders continued to tighten terms for marginal borrowers. Total private housing starts were unchanged in July after having rebounded in June from a May decline. Data on home sales in recent months continued to suggest that demand for single-family housing was still relatively buoyant.

Real business fixed investment increased substantially further in the second quarter, reflecting a broad-based surge in spending on producers' durable equipment. Real outlays for office and computing equipment continued to grow rapidly as prices of personal computers and networking equipment remained on a steep downtrend. Spending for communications equipment grew at a slower pace in the second quarter, but recent orders for such equipment pointed to larger increases in the current quarter. Nonresidential construction activity was sluggish in the second quarter. While available information on construction contracts suggested little improvement in building activity in coming months, prices for commercial real estate had risen slightly and vacancy rates had declined.

Nonfarm business inventories increased rapidly in the second quarter, but there were few signs of inventory imbalances. In June, the pace of inventory investment in manufacturing slowed from the rapid average rate for

April and May, and the inventory–shipments ratio for the sector was at a very low level. In wholesale trade, stocks rose sharply in June after little net change over the two previous months. Despite the June increase, the stock–sales ratio was at the middle of its relatively narrow range of the past year. At the retail level, the rise in inventories in June retraced only part of the May decline; the inventory–sales ratio for the sector also was near the middle of its range for the last year.

The nominal deficit on U.S. trade in goods and services was slightly smaller on balance over April and May than the downward-revised average rate in the first quarter. Measured against their first-quarter levels, the value of exported goods and services grew more than the value of imports over the April–May period. The largest increases in exports were in machinery and aircraft and parts, while the biggest gains in imports were in consumer goods, computers, and capital goods other than computers. The available information suggested that in recent months economic activity had expanded further in all the major foreign industrial countries except Japan. Growth continued to be robust in Canada and the United Kingdom and apparently remained moderate in France and Germany. Economic activity in Japan had slowed after a rise in that country's consumption tax in April.

Consumer price inflation picked up slightly in July from the slow pace in each of the previous four months; a small decline in energy prices offset a further increase in food prices. The index for items other than food and energy rose in July at the same low rate recorded for both the first six months of 1997 and the twelve months ended in July. At the producer level, prices of finished goods edged down for a seventh consecutive month, reflecting a further drop in food prices. Prices of finished goods other than food and energy were unchanged over the twelve months ended in July. At earlier stages of production, producer prices for core intermediate materials rose slightly over the year ended in July and prices of core crude materials increased by a larger amount over the same period. Growth in hourly compensation of private industry workers picked up somewhat in the second quarter, but the rise in compensation over the year ended in June matched the advance over the comparable year-earlier period. Average hourly earnings of production and nonsupervisory workers were unchanged in July, and the rise in such earnings over the twelve months ended in July also was the same as in the year-earlier period.

At its meeting on July 1–2, 1997, the Committee adopted a directive that called for maintaining the existing degree of pressure on reserve positions. Because the Committee continued to see a potential need for some tightening of monetary policy to counter rising inflationary pressures, the directive included a bias toward a possible firming of reserve conditions during the intermeeting period. The reserve market conditions associated with this directive were expected to be consistent with moderate growth of M2 and M3 over coming months.

Open market operations were directed throughout the intermeeting period toward maintaining the existing degree of pressure on reserve positions, and the average federal funds rate for the period was at the Committee's intended level of 5½ percent. Most other market interest rates declined further on balance over the period in an atmosphere of greater volatility in financial markets. The net decline in market rates seemed to have reflected a judgment by market participants that the outlook for inflation had improved slightly on balance and that the likelihood of any tightening of monetary policy in coming months had receded a little further. Share prices in equity markets increased on balance over the period.

In foreign exchange markets, the trade-weighted value of the dollar in terms of the other G-10 currencies rose significantly on balance over the intermeeting period. The appreciation of the dollar was uneven against the currencies of the major foreign industrial countries. The dollar's substantial increase against the German mark and other continental European countries reflected both the continuing favorable developments in the U.S. economy and persisting market concerns that difficulties faced by the major European countries would lead to policies that might detract from strength in the euro. The dollar rose only slightly against the yen. That currency came under downward pressure in reaction to incoming data suggesting a somewhat-greater-than-expected falloff in demand following the recent increase in the consumption tax, but the release of the June current account surplus late in the intermeeting period rekindled market concerns about Japanese external balances and led to some appreciation of the yen.

M2 expanded at a moderate pace over June and July after having fluctuated sharply in April and May as a result of tax-related flows. Data for early August suggested a somewhat faster rate of M2 growth in association with heavier inflows to retail money funds; the latter might have been related to heightened demand for liquidity as a result of recently higher volatility in bond and equity markets. For the year through July, M2 expanded at a rate near the upper bound of its range. M3 also fluctuated sharply over April and May and grew at a relatively moderate rate in June. M3 surged in July, however, as heavy volumes of large time deposits were issued by U.S. branches of foreign banks to pay down borrowings from their overseas offices and by domestic banks to counter the runoff of government deposit accounts; the latter two sources of funds are not included in M3. For the year through July, M3 expanded at a rate appreciably above the upper bound of its range. Total domestic nonfinancial debt had continued to expand in recent months at a rate near the middle of its range.

The staff forecast prepared for this meeting suggested that the expansion of the economy would be damped in the second half of the year by a slowing of inventory accumulation from the unsustainably brisk pace in the first half of the year. In 1998, the economy would expand at a pace in line with the growth of its estimated potential. Growth of consumer spending, supported by high levels of household wealth and projected further gains in employment and income, was expected to be relatively brisk over the forecast horizon. Business spending on equipment and structures was anticipated to continue to outpace the overall expansion of the economy, though the differential would tend to narrow over time in association with the gradual diminution of increases in sales and profits that was expected in conjunction with moderating economic growth. Housing construction was projected to drift lower over the forecast horizon. The staff anticipated that the external sector would exert some mild restraint on the expansion of economic activity. With labor compensation gradually accelerating in the context of higher resource utilization, core consumer price inflation was forecast to drift slightly higher.

The Committee's discussion of current and prospective economic developments highlighted statistical and anecdotal evidence of a solid economic performance, including indications of a rebound in final demand after a lull during the spring and the persistence of relatively subdued, and by some measures declining, inflation. Growth in consumer spending had slowed sharply, and a surge in inventory accumulation had accounted for much of the expansion of economic activity in the second quarter. Looking ahead, the members did not believe that recent developments had altered the prospect that the economy would settle into a pattern of moderate growth approximating its potential. Such a forecast was subject to considerable uncertainty, and several members observed that the risks appeared to be mostly in the direction of stronger growth in demand. With regard to the outlook for inflation, widespread evidence of very tight labor markets was associated with scattered indications that the rise in labor compensation might be accelerating, but overall labor costs had remained relatively damped and price inflation restrained. Gains in productivity and muted increases in nonlabor costs probably also were contributing to holding producer costs under good control. Nonetheless, the members remained concerned about the risks of rising inflation, especially if somewhat-faster-than-projected growth in economic activity were to occur and add to pressures on resources in an economy that already seemed to be operating close to, or perhaps even above, its sustainable potential.

The uncertain prospects for inventory investment were a dominant factor in the outlook for economic activity over the nearer term. The accumulation of inventories had been unusually high in the second quarter according to the available evidence. There was no broad sense of an undesired buildup, but the rate of inventory investment would have to be reined in if an overhang were to be averted. A concern in this regard was that the apparent upturn in final demand, particularly if it proved to be somewhat stronger than currently expected, and related business optimism about sales prospects might well result in a further buildup of inventories at a relatively rapid rate. While such a development was not viewed as the most likely outcome and, indeed, less-than-projected strength in the inventory sector could not be ruled out, relatively rapid inventory accumulation in the context of persisting above-trend growth in final demand would generate additional pressure on resources and heighten the risks of accelerating inflation.

With regard to the prospects for final demand in key sectors of the economy, members noted that the appreciable rebound in consumer spending followed a weak second quarter, and some moderation in the growth of such spending was likely later this year and in 1998. Even so, favorable prospects for employment and incomes and the large gains that had occurred in financial wealth suggested that consumer expenditures were likely to be well maintained over the projection horizon. The high level of consumer confidence reported by consumer surveys was another supporting factor in this favorable outlook,

In the area of business fixed investment, a strong upward trend in outlays for new equipment was thought likely to persist, notably in the computer-related and the telecommunications industries. Anecdotal reports also pointed to appreciable strength in commercial construction activity, including office structures, hotels, and warehouses in various parts of the country. Indeed, in some areas construction activity was said to be limited only by shortages of qualified labor.

Positive factors in the outlook for business investment included the persistence of a high level of profits, an accommodative financial climate, and the rapid obsolescence of high-tech equipment. There were, nonetheless, indications of some moderation in commercial construction activity in a number of areas, including reports of developing overcapacity of retail space in shopping centers. Spending for basic industrial equipment also was likely to soften, given moderating growth in overall final demand in line with current forecasts.

Housing activity continued to display considerable vigor in many parts of the nation as evidenced by available statistics and anecdotal reports. The affordability of housing and the very large increases that had occurred in stock market wealth clearly were supportive factors. Concurrently, however, there were indications of slowing in residential building activity in several areas. On balance, some moderation in housing construction appeared likely over the projection horizon in keeping with longer-term population and other trends affecting such construction.

In the Committee's discussion of the prospects for inflation, members commented that a number of factors could be cited to explain the persistence of relatively subdued inflation this year despite high levels of resource use. Among those factors were the appreciation of the dollar and its effects on prices of imports and competing domestic products, a significant decline in world oil prices, the relatively sluggish performance of many foreign economies that had tended to moderate prices of products traded in world markets, and relatively large grain harvests in the United States that had curbed pressures on food prices. However, the underlying reasons for the favorable price trends were not entirely clear. Labor costs were still rising appreciably less than would have been expected on the basis of past experience under similarly tight labor market conditions. Explanations tended to focus on the concerns about job security felt by many workers, the muted rise in the costs of worker benefits, notably for health care, and the increased use of innovative and highly targeted methods of compensation. With regard to the market pricing of goods, businesses tended to cite highly competitive conditions across the nation that made it very difficult to raise prices and gave impetus to efforts to improve productivity. Indeed, the available evidence suggested that the profits of business concerns generally had continued to increase in the second quarter, implying that productivity had been rising at a pace that exceeded published estimates by a significant margin.

Even though inflation had not accelerated, some signs were beginning to emerge that wages and other labor costs might be experiencing increasing pressure. These included some limited evidence that job security concerns might be diminishing and multiplying anecdotal reports of a less benign outlook for health care costs. Some members commented that the outcome of the recent labor negotiations involving a very large package delivery firm might well be a harbinger of more militant labor negotiating attitudes. Against this background, members expressed concern that a further increase in labor utilization rates could put substantial upward pressures on wages that eventually would work their way through to prices.

In the Committee's discussion of policy for the intermeeting period ahead, all the members endorsed a proposal to maintain an unchanged policy stance. Underlying economic conditions and the outlook for economic activity and inflation had changed little in recent months.

The most likely outcome of the current policy stance was growth near potential and some pickup in inflation as the effects of special factors holding it down abated. For the present, monetary policy appeared to be appropriately positioned to foster the Committee's objectives of resisting an intensification of inflationary pressures while supporting a fully employed economy. The level of real short-term interest rates was relatively high by historical standards and provided some assurance that the current stance of policy would not accommodate a significant increase in underlying inflationary pressures. Nonetheless, the members remained concerned about the outlook for inflation. Although some decline in inflation could not be ruled out, persistence of the current degree of tightness in labor markets, consistent with the economy growing at a pace near its potential, could at some point begin to put more pressure on costs and prices, and growth somewhat above potential, which some members saw as a distinct possibility, would be even more likely to produce that result. While there were no current indications that inflation might be accelerating and no policy move was called for at this time, the members saw a need for continuing vigilance. As at earlier meetings, a number of them expressed the view that an anticipatory policy move to counter intensifying inflationary pressures likely would be needed at some point.

In the Committee's discussion of possible adjustments to policy during the intermeeting period, members agreed that the retention of an asymmetric directive toward tightening was consistent with their view that the risks remained biased toward a rise in inflation. Accordingly, while they did not attach a high probability to the prospect that the incoming information would warrant a tightening move during the intermeeting period, they continued to view the next policy move as more likely to be in the direction of some firming than toward easing.

The members reviewed proposals for rewording the operational paragraph of the directive for the purpose of updating and clarifying the description of the Committee's instructions to the Manager of the System Open Market Account and to conform the directive wording with current public announcement practices regarding the Committee's policy decisions. In particular, the directive would in the future include specific reference to the federal funds rate that the Committee judged to be consistent with the stance of monetary policy. The Committee also modified the present sentence relating to the intermeeting bias in the directive to recognize that changes in the stance of policy are now expressed in terms of the federal funds rate. These changes were not intended to alter the substance of the directive or the Committee's operating procedures.

At the conclusion of the Committee's discussion, all the members expressed their support of a directive that called for maintaining conditions in reserve markets that were consistent with an unchanged federal funds rate of about 5½ percent. All the members also agreed on the desirability of retaining a bias in the directive toward the possible firming of reserve conditions and a higher federal funds rate during the intermeeting period. Accordingly, in the context of the Committee's long-run objectives for price stability and sustainable economic growth, and giving careful consideration to economic, financial, and monetary developments, the Committee decided that a somewhat higher federal funds rate would be acceptable or a slightly lower federal funds rate might be acceptable during the intermeeting period. The reserve conditions contemplated at this meeting were expected to be consistent with moderate expansion in M2 and M3 over coming months.

The Federal Reserve Bank of New York was authorized and directed, until instructed otherwise by the Committee, to execute transactions in the System Account in accordance with the following domestic policy directive:

The information reviewed at this meeting suggests that economic activity is expanding at a moderate pace. In labor markets, hiring remained robust at midyear, and the civilian unemployment rate, at 4.8 percent in July, matched its low for the current economic expansion. Industrial production increased relatively slowly in July, owing in part to a temporary drop in motor vehicle assemblies. Retail sales rose briskly in June and July after having changed little over the preceding three months. Housing starts rebounded in June and July after having weakened in May. Business fixed investment increased substantially further in the second quarter and available indicators point to further sizable gains in the current quarter. The nominal deficit on U.S. trade in goods and services narrowed slightly on balance over April and May from its downward-revised average rate in the first quarter. Price inflation has remained subdued and increases in labor compensation have been moderate.

Market interest rates generally have declined somewhat further since the start of the Committee meeting on July 1–2, 1997. Share prices in equity markets have increased on balance. In foreign exchange markets, the trade-weighted value of the dollar in terms of the other G-10 currencies rose significantly on balance over the intermeeting period.

After fluctuating sharply from April to May, growth of M2 was at a moderate pace over June and July and that of M3 picked up to a relatively rapid rate. For the year through July, M2 expanded at a rate near the upper bound of its range for the year and M3 at a rate appreciably above the upper bound of its range. Total domestic nonfinancial debt has continued to expand in recent months at a rate near the middle of its range.

The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. In furtherance of these objectives, the Committee at its meeting in July reaffirmed the ranges it had established in February for growth of M2 and M3 of 1 to 5 percent and 2 to 6 percent respectively, measured from the fourth quarter of 1996 to the fourth quarter of 1997. The range for growth of total domestic nonfinancial debt was maintained at 3 to 7 percent for the year. For 1998, the Committee agreed on a tentative basis to set the same ranges as in 1997 for growth of the monetary aggregates and debt, measured from the fourth quarter of 1997 to the fourth quarter of 1998. The behavior of the monetary aggregates will continue to be evaluated in the light of progress toward price level stability, movements in their velocities, and developments in the economy and financial markets.

In the implementation of policy for the immediate future, the Committee seeks conditions in reserve markets consistent with maintaining the federal funds rate at an average of around 5½ percent. In the context of the Committee's long-run objectives for price stability and sustainable economic growth, and giving careful consideration to economic, financial, and monetary developments, a somewhat higher federal funds rate would or a slightly lower federal funds rate might be acceptable in the intermeeting period. The contemplated reserve conditions are expected to be consistent with moderate growth in M2 and M3 over coming months.

Votes for this action: Messrs. Greenspan, McDonough, Broaddus, Guynn, Kelley, Meyer, Moskow, Parry, Mses. Phillips and Rivlin. Votes against this action: None.

Rules Regarding Availability of Information

By notation vote completed on August 20, 1997, the Committee approved for public comment a revision of its Rules Regarding the Availability of Information. The purpose of the revision is to bring the rules into conformance with the Electronic Freedom of Information

Act of 1996 (EFOIA), which amends the Freedom of Information Act (FOIA). The revision does not incorporate any substantive changes in the rules other than to conform them to the requirements of EFOIA and to update and clarify the Committee's procedures for processing FOIA requests. After review of the comments that are received from the public, the Committee will issue the rules in final form on or before October 2, 1997.

It was agreed that the next meeting of the Committee would be held on Tuesday, September 30, 1997.

The meeting adjourned at 12:40 p.m.

Donald L. Kohn
Secretary

Meeting Held on September 30, 1997

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Tuesday, September 30, 1997, at 9:00 a.m.

Present:

Mr. Greenspan, Chairman
Mr. McDonough, Vice Chairman
Mr. Broaddus
Mr. Guynn
Mr. Kelley
Mr. Moskow
Mr. Meyer
Mr. Parry
Ms. Phillips
Ms. Rivlin

Messrs. Hoenig, Jordan, Melzer, and Ms. Minehan, Alternate Members of the Federal Open Market Committee

Messrs. Boehne, McTeer, and Stern, Presidents of the Federal Reserve Banks of Philadelphia, Dallas, and Minneapolis respectively

Mr. Kohn, Secretary and Economist
Mr. Bernard, Deputy Secretary
Mr. Coyne, Assistant Secretary
Mr. Gillum, Assistant Secretary
Mr. Mattingly, General Counsel
Mr. Baxter, Deputy General Counsel
Mr. Prell, Economist

Messrs. Cecchetti, Goodfriend, Eisenbeis, Hunter, Lindsey, Promisel, Siegman, Slifman, and Stockton, Associate Economists

Mr. Fisher, Manager, System Open Market Account

Mr. Ettin, Deputy Director, Division of Research and Statistics, Board of Governors

Messrs. Madigan and Simpson, Associate Directors, Divisions of Monetary Affairs and Research and Statistics respectively, Board of Governors

Messrs. Alexander, Hooper, and Ms. Johnson, Associate Directors, Division of International Finance, Board of Governors

Ms. Low, Open Market Secretariat Assistant, Division of Monetary Affairs, Board of Governors

Mr. Varvel, First Vice President, Federal Reserve Bank of Richmond

Ms. Browne, Messrs. Dewald, Hakkio, Ms. Krieger, Messrs. Lang, Rolnick, Rosenblum, and Sniderman, Senior Vice Presidents, Federal Reserve Banks of Boston, St. Louis, Kansas City, New York, Philadelphia, Minneapolis, Dallas, and Cleveland respectively

Mr. Judd, Vice President, Federal Reserve Bank of San Francisco

By unanimous vote, the minutes of the meeting of the Federal Open Market Committee held on August 19, 1997, were approved.

The Manager of the System Open Market Account reported on developments in foreign exchange and international financial markets in the period since the previous meeting on August 19, 1997. There were no open market transactions in foreign currencies for System account since that meeting, and thus no vote was required of the Committee.

The Manager also reported on developments in domestic financial markets and on System open market transactions in government securities and federal agency obligations during the period August 19, 1997, through September 29, 1997. By unanimous vote, the Committee ratified these transactions.

The Committee then turned to a discussion of the economic outlook and the conduct of monetary policy over the intermeeting period ahead. A summary of the economic and financial information available at the time of the meeting and of the Committee's discussion is provided below, followed by the domestic policy directive that was approved by the Committee and issued to the Federal Reserve Bank of New York.

The information reviewed at this meeting suggested that economic activity had expanded briskly further in the third quarter. The expansion was paced by robust growth in consumer spending and substantial further increases in business investment expenditures. Housing demand seemed to have been well maintained over the summer. Employment and production had risen considerably further since midyear. Despite widespread indications of tight labor markets, increases in labor compensation had been moderate in recent months, and price inflation had remained subdued.

Private nonfarm payroll employment rose substantially over July and August despite the retarding effects of a work stoppage at a major package shipping firm. Aggregate weekly hours of production or nonsupervisory workers were considerably above their second-quarter average over the two months. The civilian unemployment rate, at 4.9 percent in August, was marginally above its low for the current economic expansion.

Industrial production increased considerably in July and August, extending a relatively brisk advance over the first half of the year. The output of business equipment rose strongly over the two months, with sizable gains in all major categories, and the output of consumer nondurables turned up after having displayed some weakness in earlier months of the year. The production of consumer durables also increased on balance over the two months. After having risen somewhat in other recent months, the utilization of total manufacturing capacity was up appreciably in August, reaching its highest level since the spring of 1995.

Retail sales were up substantially over the summer after having edged lower during the spring. The upturn in recent months included a rebound in sales at automotive dealers following some weakness in earlier months. Sales at non-auto durable and at nondurable goods stores also strengthened after having declined on balance during the second quarter. The pickup in consumer spending occurred against a backdrop of further strong gains in incomes and household net worth that, according to recent surveys, had fostered high levels of consumer confidence. In addition, credit continued to be readily available to most consumers. Total private housing starts and building permits declined in August to levels somewhat below their averages in earlier months of the year, but data on overall home sales and builder ratings of new home sales continued to suggest that demand for single-family housing was still relatively buoyant.

Real business fixed investment had remained on a steep uptrend since mid-year, with exceptional ongoing demand for computers and communications equipment and relatively robust demand in other categories of business equipment as well. Nonresidential construction activity appeared to have rebounded somewhat in late spring and early summer after having declined moderately earlier in the year. While new construction contracts displayed little trend, favorable conditions for nonresidential construction were suggested by low vacancy rates, rising prices for commercial real estate, and a widespread availability of financing.

The accumulation of nonfarm business inventories slowed substantially in July (latest data) from its average pace in the second quarter. Inventory investment in manufacturing was only a bit below its pace in the second quarter, but the inventory–shipments ratio for the sector remained at a very low level. In wholesale trade, stocks fell after a sharp buildup in June, and the stock–sales ratio for this sector was at the middle of its relatively low range for the past year. At the retail level, a rise in inventories in July about matched that in June and the inventory–sales ratio for the sector also was near the middle of its range for the past year.

The nominal deficit on U.S. trade in goods and services widened substantially in July, reflecting both a decline in exports and a rise in imports. The lower exports of goods and services were associated with decreases in most trade categories and left total exports slightly below their relatively high level of the second quarter. The July increase in imports also was spread among nearly all trade categories and brought total imports of goods and services to a level somewhat above the average for the second quarter. The available information suggested that economic activity expanded further in recent months in all the major foreign industrial countries except Japan. Growth remained relatively robust in Canada and the United Kingdom, and activity apparently picked up in France and Germany after having been sluggish early in the year. Economic activity in Japan declined appreciably in the second quarter, and more recent information provided little clear evidence of subsequent strength.

Price inflation had remained subdued. Consumer price inflation picked up slightly in July and August from a slow rate of increase in each of the previous four months; reduced but still appreciable increases in food prices contributed to the larger advance in both months, and a sizable rise in energy prices lifted the index in August. At the producer level, the price index for finished goods rose moderately in August after having fallen for seven consecutive months; the August rise largely reflected a jump in energy prices. Over the twelve months ended in August, consumer prices were up considerably less than in the previous twelve months, while producer prices of finished goods were down slightly after having increased moderately in the previous twelve months. The behavior of these broad measures of inflation excluding the effects of food and energy prices also was favorable over the year ended in August, albeit slightly less so. Average hourly earnings of production and nonsupervisory workers picked up in August from a much reduced pace in July; the rise in such earnings over the twelve months ended in July was slightly above that in the previous twelve months.

At its meeting on August 19, 1997, the Committee adopted a directive that called for maintaining conditions in reserve markets that were consistent with an unchanged federal funds rate averaging about 5½ percent. The directive included a bias toward the possible firming of reserve conditions and a somewhat higher federal funds rate to reflect a consensus among the members that the economic risks remained biased toward higher inflation. Although the members did not see a high probability that likely developments would warrant a tightening of policy during the intermeeting interval, they continued to anticipate that the next policy move was more likely to be in the direction of some firming than toward some easing. The reserve market conditions associated with this directive were expected to be consistent with some slowing in the growth of M2 and M3 to more moderate rates over coming months.

Open market operations were directed throughout the intermeeting period toward maintaining the existing degree of pressure on reserve positions, and the federal funds rate averaged just slightly above the Committee's intended level of 5½ percent. Most other interest rates in short-term markets were little changed over the period. Rates on longer-term obligations were down somewhat on balance, apparently reflecting a reassessment of the outlook for inflation by some market participants in the light of unexpectedly low inflation and other statistics released during the latter part of the period. The downward movement in long-term interest rates resulted in some further flattening of the slope of the yield curve and appeared consistent with an interpretation that market participants saw little likelihood of any tightening of monetary policy in coming months. Share prices in equity markets continued to display considerable volatility but increased appreciably further on balance over the intermeeting interval.

In foreign exchange markets, the dollar experienced mixed changes in relation to major foreign currencies, largely reflecting diverging economic developments abroad. On balance, the dollar's trade-weighted value in terms of the other G-10 currencies declined somewhat over the intermeeting period. The dollar was down considerably against the mark as data suggesting a pickup in German economic activity and inflation led to market speculation concerning a possible increase in short-term German interest rates. The dollar also registered sizable declines over the period against a number of other European currencies. On the other hand, the dollar rose appreciably in relation to the Japanese yen, which came under selling pressure against the background of continuing sluggish economic conditions in Japan, persistent problems in its financial system, and concerns about the potential effect on Japan of the recent depreciations of Southeast Asian currencies. The dollar also strengthened somewhat in terms of the British pound, in part as a result of some indications that economic activity in the United Kingdom was not as strong as expected and the sizable declines that had occurred recently in that nation's long-term interest rates.

M2 expanded at a rapid pace in August and continued to grow at a still robust though diminished rate in September according to the limited data available for that month. The strength of M2 and also that of M3 was related at least in part to changes in the allocation of financial assets and liabilities rather than to the growth in spending; in particular, the volatility in the stock market evidently fostered a redirection of funds to M2 assets, among others, and included heavy inflows to the money market funds component of M2. For the year through August, M2 rose at a rate somewhat above the upper bound of the Committee's range. M3 grew at an exceptionally rapid rate over the summer months, with only few signs of moderation in September according to the partial data available for that month. Apart from the strength in its M2 components, the increase in this aggregate reflected bank substitution of large time deposits for foreign borrowings to finance credit growth and also reflected substantial inflows to institution-only money funds. For the year through August, M3 expanded at a rate well above the upper bound of its range. Total domestic nonfinancial debt continued to increase at a relatively moderate rate in recent months.

The staff forecast prepared for this meeting suggested that the economy would expand at a pace significantly above that anticipated earlier for the second half of the year and the early part of 1998, but economic growth was likely to moderate appreciably to a more sustainable rate later. In the near term, business fixed investment appeared to be providing surprisingly strong impetus to income growth, and rising levels of wealth were stimulating robust consumer demand. With sales so strong, the downward adjustment in inventory investment that had been anticipated in the previous staff forecast seemed likely to occur more gradually. The projected strength in aggregate demand appeared likely to intensify pressures on resources and lead to some pickup in inflation. Less accommodative financial market conditions were anticipated to damp these tendencies over time.

In the Committee's discussion of current and prospective economic developments, members commented on the continued remarkable performance of the economy. Strength in consumer spending and further acceleration in capital investment sparked faster-than-expected growth in the third quarter, and relatively brisk economic expansion seemed to be in prospect for a period ahead in the context of very positive business and consumer sentiment, strong demands for capital goods, and favorable financial conditions. The rate of expansion might subsequently be expected to slow as stocks of business capital and consumer durable goods built up relative to sales and incomes, inventory investment moderated somewhat, and the recent strength of the dollar began to exert a drag on exports. It was an open question, however, as to whether these influences would be sufficient to slow the growth of demands for goods and services to a more sustainable pace, and many members suggested that the risks to the forecast were on the side of increases in final demands that would press more intensely against the available resources. Despite high levels of resource utilization, inflation and inflationary expectations had remained subdued to date, reflecting to some extent special influences like the rise in the foreign exchange value of the dollar. Moreover, sizable gains in productivity combined with moderate increases in wages and salaries seemed to have contributed to keeping unit labor costs and prices under control. However, the growing tightness in labor markets in many parts of the country was being accompanied by some signs of rising pressures on labor compensation, including the use of special bonuses and other innovative compensation initiatives that are not included in the usual statistical measures of labor costs. In the circumstances, members saw a risk of added wage and price inflation if economic activity did not slow to a more sustainable pace consistent at a minimum with no further appreciable increase in labor utilization rates.

With regard to the prospects for final demand in key sectors, members took note of the rebound in consumer expenditures after a sluggish second quarter. Solid gains in employment, incomes, and household net worth were seen as sustaining further robust expansion in consumer spending. In addition, members anticipated that continued further rapid expansion in investment expenditures by business firms for equipment and structures would provide strong underlying support for the economic expansion. High rates of return on investments in equipment, particularly for computers and communications equipment where prices were falling rapidly, coupled with ready financing from both internal cash flows and external sources were inducing firms to undertake large investment programs. Such investments would expand capacity, improve productivity, and lower costs of production. Anecdotal reports suggested a mixed picture in nonresidential real estate markets. In much of the country, commercial and office vacancies were declining from already low levels and lease rates were rising. Shortages of construction workers were said to be holding back construction in some areas, but in other parts of the country there were indications of some moderation in construction activity and of emerging overcapacity in some markets. The ready availability of financing was a supportive factor in the outlook for nonresidential construction.

A gradual decline in housing activity was expected to exert only mild restraint on the increase of economic activity. Solid job and income growth, the high level of household wealth, and the low cash flow burden of homeownership would continue to provide good support for housing demand. In this regard, recent statistical and anecdotal information indicated that home sales were holding up well across the country, although higher-priced homes appeared to be selling relatively slowly in some areas.

In the Committee's discussion of the prospects for inflation, members discussed the relative absence of price pressures in an environment of increasingly tight labor markets across the country and rising levels of manufacturing capacity utilization. In labor markets, costs were increasing much less than would have been expected on the basis of previous experience under similarly tight conditions. Among the possible explanations for this outcome were persisting concerns about job security; the muted rise in worker benefits, notably health care; and the increasing use by employers of more flexible and innovative means to attract and retain workers that were in high demand. Moreover, it was suggested that, at least in manufacturing, productivity had risen unusually rapidly of late, allowing corporations to hold the line on prices despite increases in labor costs. While the underlying reasons for the favorable inflation trends were not entirely clear, the members noted that, in addition to subdued increases in labor costs, the appreciation of the dollar and the relatively sluggish performance of many foreign industrial economies seemed to be contributing to the better-than-expected inflation performance by holding down prices in world commodity markets and prices of imported goods more generally. These developments also added to competitive pressures on businesses, which together with customer resistance were making it very difficult for firms to raise prices to reflect their higher costs.

The members commented that while few signs of rising price inflation had surfaced, the widespread tautness of labor markets and the emergence of scattered indications of increased pressure on wages and other labor costs were cause for concern. Anecdotal reports suggested that increases in health care costs were likely to turn up, and there were indications that fears about job security might be diminishing and that workers were becoming less reluctant to leave their jobs before finding better ones. In addition, businesses were reporting increasing difficulty in hiring and retaining qualified workers. Growth in labor demand had been outpacing sustainable increases in labor supply; these reports suggested that the risk of an acceleration in labor compensation was rising.

In the Committee's discussion of policy for the intermeeting period ahead, all the members endorsed a proposal to maintain an unchanged policy stance, but several also indicated that economic developments could well require a tightening of policy in the relatively near future. Members observed in this regard that some factors that had contributed to a currently subdued rate of inflation, notably the appreciation of the dollar, damped wage demands, and relatively limited increases in the cost of health benefits, were not likely to continue to exert the same restraining influence. Moreover, final demands had been unexpectedly strong, with economic activity and the associated demand for labor expanding at an unsustainable pace for some time, and it was unclear whether without policy action overall demands would moderate sufficiently to avoid increasing pressures on resources. In the circumstances, the risks to the economy appeared to be strongly tilted toward rising inflation whose emergence would in turn threaten the sustainability of the expansion. Several members emphasized in this regard that a tightening move could be most effective if it were implemented preemptively, before inflation had time to gather upward momentum and become embedded in financial asset prices and in business and consumer decision-making.

There were, nonetheless, a number of reasons for delaying a tightening of policy. The behavior of inflation had been unexpectedly benign for an extended period of time for reasons that were not fully understood. Forecasts of an upturn in inflation were therefore subject to a considerable degree of uncertainty, and the expansion of economic activity could still slow to a noninflationary pace. Members also commented that a policy tightening was not anticipated at this time and such an action might therefore have unintended adverse effects on financial markets. Members recognized that from the standpoint of the level of real short-term interest rates, monetary policy could already be deemed to be fairly restrictive. Several noted, however, that credit from a wide variety of lenders appeared to be amply available in financial markets on favorable terms, perhaps overly so in present circumstances, and some also noted that the strength in the broad measures of money in recent months suggested that policy was not restraining liquidity or financial conditions more generally. In the course of the Committee's discussion of these diverging considerations, a consensus emerged for maintaining a steady policy course at this time, but members also expressed the need for a heightened degree of vigilance as they continued to assess ongoing developments for signs that inflation might intensify in the future.

In their discussion of possible adjustments to policy during the intermeeting period, all the members indicated that they wanted to retain in the operating paragraph of the directive the existing asymmetry toward restraint that was initially adopted at the May meeting. Such a directive was consistent with their view that the risks continued to be biased toward rising inflation and indeed with the view of most members that those risks might have increased. Accordingly, while the probability that the incoming information would warrant a tightening move during the intermeeting period might not be high, the members continued to view the next policy move as more likely to be in the direction of some firming than toward easing.

At the conclusion of the Committee's discussion, all the members supported a directive that called for maintaining conditions in reserve markets that were consistent with an unchanged federal funds rate of about 5½ percent. All the members also agreed on the desirability of retaining a bias in the directive toward the possible firming of reserve conditions and a higher federal funds rate during the intermeeting period. Accordingly, in the context of the Committee's long-run objectives for price stability and sustainable economic growth, and giving careful consideration to economic, financial, and monetary developments, the Committee decided that a somewhat higher federal funds rate would be acceptable or a slightly lower federal funds rate might be acceptable during the intermeeting period. The reserve conditions contemplated at this meeting were expected to be consistent with some moderation in the expansion in M2 and M3 over coming months.

The Federal Reserve Bank of New York was authorized and directed, until instructed otherwise by the Committee, to execute transactions in the System Account in accordance with the following domestic policy directive:

The information reviewed at this meeting suggests that growth of economic activity remains brisk. In labor markets, hiring continued robust over the summer months and the civilian unemployment rate, at 4.9 percent in August, remained near its low for the current economic expansion. Industrial production increased considerably further in July and August. Retail sales have risen sharply over recent months after a pause during the spring. Housing starts declined in July and August, but home sales have been strong. Business fixed investment has increased substantially further since midyear and available indicators point to further sizable gains in coming months. After narrowing somewhat in the second quarter, the nominal deficit on U.S. trade in goods and services widened substantially in July. Inventory investment in July was well below the average pace in prior months of 1997. Price inflation has remained subdued and increases in labor compensation have been moderate in recent months.

Most market interest rates are about unchanged on balance since the day before the Committee meeting on August 19, 1997. Share prices in equity markets have increased considerably over the period, with some stock price indexes reaching new highs. In foreign exchange markets, the trade-weighted value of the dollar in terms of the other G-10 currencies declined somewhat on balance over the intermeeting period.

Growth of M2 appears to have moderated somewhat in September from a very rapid pace in August, while expansion of M3 remained very strong in both months. For the year through August, M2 expanded at a rate somewhat above the upper bound of its range for the year and M3 at a rate substantially above the upper bound of its range. Total domestic nonfinancial debt has continued to expand in recent months at a pace near the middle of its range.

The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. In furtherance of these objectives, the Committee at its meeting in July reaffirmed the ranges it had established in February for growth of M2 and M3 of 1 to 5 percent and 2 to 6 percent respectively, measured from the fourth quarter of 1996 to the fourth quarter of 1997. The range for growth of total domestic nonfinancial debt was maintained at 3 to 7 percent for the year. For 1998, the Committee agreed on a tentative basis to set the same ranges as in 1997 for growth of the monetary aggregates and debt, measured from the fourth quarter of 1997 to the fourth quarter of 1998. The behavior of the monetary aggregates will continue to be evaluated in the light of progress toward price level stability, movements in their velocities, and developments in the economy and financial markets.

In the implementation of policy for the immediate future, the Committee seeks conditions in reserve markets consistent with maintaining the federal funds rate at an average of around 5½ percent. In the context of the Committee's long-run objectives for price stability and sustainable economic growth, and giving careful consideration to economic, financial, and monetary developments, a somewhat higher federal funds rate would or a slightly lower federal funds rate might be acceptable in the intermeeting period. The contemplated reserve conditions are expected to be consistent with some moderation in the growth of M2 and M3 over coming months.

Votes for this action: Messrs. Greenspan, McDonough, Broaddus, Guynn, Kelley, Meyer, Moskow, Parry, Mses. Phillips and Rivlin. Votes against this action: None.

It was agreed that the next meeting of the Committee would be held on Wednesday, November 12, 1997.

The meeting adjourned at 12:45 p.m.

Donald L. Kohn
Secretary

Meeting Held on November 12, 1997

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Wednesday, November 12, 1997, at 9:00 a.m.

Present:

Mr. Greenspan, Chairman
Mr. McDonough, Vice Chairman
Mr. Broaddus
Mr. Ferguson
Mr. Gramlich
Mr. Guynn
Mr. Kelley
Mr. Moskow
Mr. Meyer
Mr. Parry
Ms. Phillips
Ms. Rivlin

Messrs. Hoenig, Jordan, Melzer, and Ms. Minehan, Alternate Members of the Federal Open Market Committee

Messrs. Boehne, McTeer, and Stern, Presidents of the Federal Reserve Banks of Philadelphia, Dallas, and Minneapolis respectively

Mr. Kohn, Secretary and Economist
Mr. Bernard, Deputy Secretary
Mr. Coyne, Assistant Secretary
Mr. Gillum, Assistant Secretary
Mr. Mattingly, General Counsel
Mr. Baxter, Deputy General Counsel
Mr. Prell, Economist
Mr. Truman, Economist

Messrs. Cecchetti, Goodfriend, Eisenbeis, Lindsey, Promisel, Slifman, and Stockton, Associate Economists

Mr. Fisher, Manager, System Open Market Account

Messrs. Madigan and Simpson, Associate Directors, Divisions of Monetary Affairs and Research and Statistics respectively, Board of Governors

Messrs. Alexander, Hooper, and Ms. Johnson, Associate Directors, Division of International Finance, Board of Governors

Ms. Low, Open Market Secretariat Assistant, Division of Monetary Affairs, Board of Governors

Ms. Pianalto and Mr. Rives, First Vice Presidents, Federal Reserve Banks of Cleveland and St. Louis respectively

Messrs. Dewald, Hakkio, Rolnick, and Sniderman, Senior Vice Presidents, Federal Reserve Banks of St. Louis, Kansas City, Minneapolis, and Cleveland respectively

Messrs. Bentley, Meyer, and Rosengren, Vice Presidents, Federal Reserve Banks of New York, Philadelphia, and Boston respectively

Ms. Gonczy and Mr. Koenig, Assistant Vice Presidents, Federal Reserve Banks of Chicago and Dallas respectively

Mr. Trehan, Research Officer, Federal Reserve Bank of San Francisco

By unanimous vote, the minutes of the meeting of the Federal Open Market Committee held on September 30, 1997, were approved.

The Manager of the System Open Market Account reported on developments in foreign exchange and international financial markets in the period since the previous meeting on September 30, 1997. There were no System open market transactions in foreign currencies during this period, and thus no vote was required of the Committee.

The Manager also reported on developments in domestic financial markets and on System open market transactions in government securities and federal agency obligations during the period September 30, 1997, through November 11, 1997. By unanimous vote, the Committee ratified these transactions.

By unanimous vote, paragraph 1.A of the Authorization for Domestic Open Market Operations was amended to raise from $8 billion to $12 billion the dollar limit on intermeeting changes in System Account holdings of U.S. government and federal agency securities for the intermeeting period through December 16, 1997. The Manager advised the Committee that, as was usually the case at this time of year, the anticipated pattern of reserve needs was such that he might want to add considerably to the System's outright holdings of U.S. government securities over the coming intermeeting period. By unanimous notation vote, the Committee subsequently approved a further increase in the intermeeting leeway to $17 billion. The increase, effective December 8, was made on the recommendation of the Manager who saw the need for substantially more outright purchases of Treasury obligations than anticipated earlier, largely in light of much greater than projected growth in currency.

With Mr. Broaddus dissenting, the Committee authorized the renewal for an additional one-year period of the System's reciprocal currency ("swap") arrangements with foreign central banks and the Bank for International Settlements. The amounts and current maturity dates of the arrangements approved for renewal are shown in the table that follows:

Foreign bank	Amount of arrangement (millions of dollars equivalent)	Term (months)	Maturity date
Austrian National Bank	250	12	12/04/97
Bank of England	3,000	↑	12/04/97
Bank of Japan	5,000		12/04/97
Bank of Norway	250		12/04/97
Bank of Sweden	300		12/04/97
Swiss National Bank	4,000		12/04/97
Bank for International Settlements:			
Swiss francs	600		12/04/97
Other authorized European currencies	1,250		12/04/97
Bank of Mexico	3,000		12/12/97
Bank of Canada	2,000		12/15/97
National Bank of Belgium	1,000		12/18/97
National Bank of Denmark	250		12/28/97
Bank of France	2,000		12/28/97
German Federal Bank	6,000		12/28/97
Bank of Italy	3,000	↓	12/28/97
Netherlands Bank	500	12	12/28/97

Mr. Broaddus dissented because he believed that the Federal Reserve's participation in foreign exchange market intervention compromises its ability to conduct monetary policy effectively. Because sterilized intervention cannot have sustained effects in the absence of conforming monetary policy actions, Federal Reserve participation in foreign exchange operations risks one of two undesirable outcomes. First, the independence of monetary policy is jeopardized if the System adjusts its policy actions to support short-term foreign exchange objectives set by the Treasury. Alternatively, the credibility of monetary policy is damaged if the System does not follow interventions with compatible policy actions, the interventions consequently fail to achieve their objectives, and the System is associated in the mind of the public with the failed operations. In these circumstances, he did not view renewal of the existing swap lines as desirable because they are used primarily to facilitate market intervention.

The Committee then turned to a discussion of the economic outlook and the conduct of monetary policy over the intermeeting period ahead.

The information reviewed at the meeting suggested that economic activity continued to grow rapidly in recent months. The further advance reflected a surge in business fixed investment and consumer spending, while housing demand remained at a high level. Significant slowing in exports and inventory investment provided only a partial offset to the strength. Accordingly, production and employment recorded further large gains. Price inflation remained subdued despite tight labor markets and a pickup in the pace of labor compensation.

Nonfarm payroll employment rose substantially further in October. Manufacturing payrolls recorded their largest rise in the current economic expansion, and aggregate weekly hours worked increased significantly; most of the gain in payrolls occurred at durable goods establishments. Hiring remained robust in the service-producing sector, led by sizable increases at computer services and engineering and management services firms. The civilian unemployment rate fell to 4.7 percent in October, its low for the current expansion.

Industrial production registered a large advance in the third quarter and apparently remained strong in October. A third-quarter surge in the manufacture of durable goods, notably of motor vehicles, aircraft, and information processing equipment, more than offset weak expansion in the output of nondurable goods and a decline in mining activity. Although the step-up in manufacturing production boosted further the rate of utilization of manufacturing capacity, the latter was somewhat below its most recent peak in January 1995.

Retail sales posted a sharp rise in the third quarter, though growth in sales of both durable and nondurable goods moderated during the quarter. Consumer spending on services also continued to increase at a relatively brisk pace. Growth in such spending was underpinned by continuing substantial gains in incomes, the cumulative increase in household net worth over the past several years, and the ready availability of credit to most consumers. Housing demand remained strong in the third quarter in association with moderate interest rates and very positive consumer assessments of homebuying conditions. Sales of both new and existing homes increased a bit, and housing starts were little changed in the third quarter from the high level recorded during the first half of the year.

Business fixed investment increased at an unusually rapid rate in the third quarter. The rise in outlays was spread across all categories of producers' durable equipment, but the largest gains were in office, computing, and communications equipment. Available data on new orders pointed to further broad-based and robust expansion in equipment spending in coming months. Nonresidential construction grew at a moderate pace in the latest quarter despite a decline in September. Available information suggested that construction would trend upward at a modest rate in coming months.

Business inventory investment appeared to have moderated substantially in the third quarter from the rapid rate of the previous quarter, and on balance stocks were at relatively low levels in relation to sales. In manufacturing, stocks rose somewhat further in September, but the inventory-to-shipments ratio for the sector declined to the low end of its range for the past twelve months. Wholesale inventories posted another sizable advance in September; the inventory–sales ratio for this sector was just above the high end of its range for the past year. Retail stocks fell in August (latest available data), more than reversing their July increase. The inventory–sales ratio for the sector also was at the low end of its range for the past year.

The nominal deficit on U.S. trade in goods and services widened substantially on balance over July and August from its rate in the second quarter. Exports of goods and services changed little on net in the July–August period, but imports rose considerably; the largest increases in imports were for aircraft and automotive products, though sizable gains also were recorded for computers, semiconductors, and industrial supplies. Available indicators of economic activity in the third quarter pointed to robust expansion in all the major foreign industrial countries except Japan, where activity rebounded only moderately from a sharp second-quarter decline. Although timely data were sparse, the economies of many Asian countries probably were weakening as their exchange rates came under pressure, problems in their financial sectors were revealed, and their monetary and fiscal policies moved toward restraint.

Consumer price inflation remained subdued in September. The increase in both overall consumer prices and the prices of consumer items other than food and energy was modest. For the twelve months ended in September, prices of consumer items other than food and energy increased by a considerably smaller amount than in the year-earlier period. At the producer level, the September rise in prices was the largest monthly increment since January 1991; nonetheless, the overall index was unchanged over the past twelve months after a sizable rise over the previous twelve-month period. The core index also decelerated on a year-over-year basis. The rate of increase in the hourly compensation of private industry workers was unchanged in the third quarter, but the advance over the past four quarters was somewhat larger than that for the previous four. Growth in average hourly earnings picked up in September and October, perhaps partly reflecting the effects of an increase in the federal minimum wage.

At its meeting on September 30, 1997, the Committee adopted a directive that called for maintaining conditions in reserve markets that were consistent with an unchanged federal funds rate averaging around 5½ percent. The Committee retained a tilt in the directive toward a possible firming of reserve conditions during the intermeeting period, reflecting its view that the risks continued to be skewed toward rising inflation. Reserve market conditions associated with this directive were expected to be consistent with some moderation in the growth of M2 and M3 over coming months.

Open market operations were directed throughout the intermeeting period toward maintaining reserve conditions consistent with the Committee's intended level of around 5½ percent for the federal funds rate, and the rate averaged close to that level over the period. Other financial markets became quite volatile from time to time. Share prices in equity markets fluctuated widely in occasionally turbulent trading activity and were down somewhat on balance over the period; equity markets in other countries, notably in Asia, also were volatile, and very large declines were recorded in some of those markets. Against this background, U.S. short-term interest rates registered small mixed changes over the period since the September 30 meeting, while Treasury bond yields declined somewhat on balance. Unexpectedly strong incoming data on U.S. producer prices, employment, and wages tended to exert upward pressures on bond yields on some days, but these were more than offset by investor desires for safety and quality, the continuing moderation in consumer inflation, and the perception engendered by international financial developments that inflation pressures were likely to remain subdued.

The dollar also was affected by the spreading financial turmoil in developing countries, appreciating significantly over the intermeeting period against the currencies of a number of Asian and Latin American countries. Much of the increase was counterbalanced, however, by a sizable decline in the dollar's trade-weighted value in terms of the currencies of the other G-10 countries. The dollar's decline against the German mark and other European currencies partly reflected diminished market expectations of potential tightening in the United States and a snugging of monetary conditions by the Bundesbank and other continental European central banks. Further progress in resolving uncertainties surrounding the European Monetary Union also may have contributed to the rise in European currencies. The dollar appreciated slightly on balance against the Japanese yen.

Growth of M2 and M3 apparently moderated further in October, though the expansion of these aggregates remained brisk. A sharp slowing of inflows to money market mutual funds accounted for much of the deceleration of M2, and an easing in the pace of issuance of large time deposits, evidently reflecting a smaller rise in bank credit, also contributed to a modest reduction in M3 growth. For the year through October, M2 expanded at a rate that was at the upper bound of the Committee's range for the year and M3 at a rate substantially above the upper bound of its range. Total domestic nonfinancial debt increased in recent months at a rate somewhat below the middle of its range.

The staff forecast prepared for this meeting suggested that the economy would continue to expand for a time at a pace considerably above its potential, but growth was expected to moderate to a more sustainable rate later. Further rapid increases in business investment would provide strong impetus to income growth in the near term, and the rise in household wealth so far in 1997 would stimulate robust consumer demand going forward. The projected strength of domestic demand would be offset to some extent by a considerable weakening in the growth of exports in response to the lagged effects of the earlier appreciation of the dollar and sharp anticipated reductions in the economic growth of Asian and other developing countries.

In the Committee's discussion of current and prospective economic developments, members focused on widespread indications of a continued solid advance in economic activity, spurred by strength in all major sectors of the domestic economy, and the persistence of subdued increases in prices. The current momentum of the expansion, together with broadly supportive financial conditions and favorable business and consumer sentiment, suggested that economic growth was likely to be well maintained, especially over the nearer term. As a consequence, the members agreed that there remained a clear risk of additional pressures on already tight resources and ultimately on prices that could well need to be curbed by tighter monetary policy. But the members also focused on two important influences that were injecting new uncertainties into this outlook. Turmoil in Asian financial markets and economies would tend to damp output and prices in the United States. To date, it appeared that the effects on the U.S. economy would be quite limited, but the ultimate extent of the adjustment in Asia was unknown, as was its spillover to global financial markets and to the economies of nations that were important U.S. trading partners. The second influence was the apparently sharp increase in productivity in the second and third quarters. This was an encouraging development, although it was too early to judge the persistence of the uptrend in productivity growth and the extent to which it might reduce the additional price pressures that would be generated in the event of an extended period of further robust economic expansion.

Strength in consumer spending had provided an important underpinning for robust economic expansion, and substantial growth was likely to persist, sustained by increases in employment and incomes, high levels of confidence, and the cumulative effects of very large gains in stock market wealth over the past several years. The outlook for capital spending also remained quite favorable because the factors that were contributing to the ongoing surge in such spending—its potential for lowering production costs in highly competitive markets and the ready availability of finance on attractive terms—were likely to persist. While private domestic demand most likely would continue to display considerable strength, both consumption and investment were somewhat vulnerable to developments in financial markets, perhaps arising from further difficulties in Asia. Increased uncertainty about asset values could engender greater caution on spending, and of course a substantial decline in equity values would reduce household wealth and raise the cost of equity capital. Some members also commented that additional appreciation of the dollar, perhaps in association with possible further turbulence in Asia and weakness in foreign economies, would have adverse implications for net exports, which already were seen as a somewhat negative factor in the economic outlook. At the same time, a stronger dollar would have a positive effect on domestic inflation over the projection horizon.

In the course of their discussion, the members gave considerable emphasis to recent developments in labor markets. Statistical indicators of rising levels of employment, low and falling rates of unemployment, and a diminishing supply of new workers were reinforced by anecdotal evidence of tight labor markets throughout the nation. The demand for many types of workers exceeded the supply in many regions, and a number of members reported that growth of economic activity in various parts of the country was being held back by the scarcity of labor. While labor compensation had accelerated, the pickup was moderate in light of the taut conditions in labor markets and some of it reflected the legislated rise in the minimum wage. Nonetheless, members cited numerous examples of efforts to attract or retain workers in especially scarce supply through a variety of bonus payments and other incentives that were not included in standard measures of labor compensation.

The effects on costs and prices of somewhat faster increases in compensation evidently were being muted by what appeared to have been a sharp advance in productivity growth in the past two quarters. The acceleration in productivity seemed to be related in part to the surge in capital spending, which had been stimulated by the ability of new equipment to enhance efficiency and hold down costs, suggesting that productivity might be on a higher trend for a time. But it also could be attributed to some extent to the strengthening in economic output; such strengthening often is associated with a pickup in productivity as producers react initially to the upturn in demand by stretching available labor further. If the pace of the economic expansion were to moderate in line with current expectations, the growth in productivity also could be expected to slow, but to an uncertain extent.

The trend in productivity gains was a key factor in the outlook for unit costs and ultimately for price inflation. As had been true for an extended period, inflation had remained relatively subdued in comparison with past experience under broadly similar economic conditions. The reasons for the relative quiescence of inflation were not fully understood, but they undoubtedly included a number of special factors beyond higher productivity such as a lagged response to earlier appreciation of the dollar and unusually damped increases in the cost of health benefits. As they had at previous meetings, members suggested that these favorable influences were likely to erode over the year ahead. A number of members again cited reports of increases in health insurance premiums next year and subsequently. More fundamentally, it was difficult to predict whether anticipated increases in labor compensation would be fully offset by productivity gains in coming quarters and whether, in turn, competitive market conditions would allow firms to raise prices to compensate for any increases in their costs. On balance, the members felt that the risks remained in the direction of rising price inflation though the extent and timing of that outcome were subject to considerable debate.

In the Committee's discussion of policy for the intermeeting period ahead, all but one member endorsed a proposal to maintain an unchanged policy stance, and all agreed that the risks remained tilted toward rising inflation. While developments in Southeast Asia were not expected to have much effect on the U.S. economy, global financial markets had not yet settled down and further adverse developments could have greater-than-anticipated spillover effects on the ongoing expansion. In this environment, with markets still skittish, a tightening of U.S. monetary policy risked an oversized reaction. Some members also emphasized that the relatively favorable trends in productivity, costs, and prices continued to raise questions about the strength and timing of any pickup in inflation. Other members stressed that the unsustainable pace of domestic demand and rising resource utilization seemed to call for a near-term tightening of policy. Some of these members noted that overall financial conditions remained quite supportive despite the recent market turmoil and high real short-term interest rates. Credit from a wide variety of lenders appeared to be amply available on favorable terms, perhaps overly so in present circumstances. Nonetheless, all but one of the members believed that in light of the uncertainties about the economic outlook, an immediate policy tightening was not needed in the absence of firmer indications that inflationary pressures might be emerging. In the view of one member, however, aggregate final demand was so strong that, with economic activity and the associated demand for labor having expanded at an unsustainable pace for some time, one could be reasonably confident that inflation would most likely pick up in the absence of policy action.

In their discussion of possible adjustments to policy during the intermeeting period, the members indicated that they wanted to retain in the operating paragraph of the directive the existing asymmetry toward restraint that was initially adopted at the May meeting. Such a directive was consistent with their view that the risks continued to be biased toward rising inflation. Accordingly, the members continued to view the next policy move as more likely to be in the direction of some firming than toward easing.

At the conclusion of the Committee's discussion, all but one member supported a directive that called for maintaining conditions in reserve markets that were consistent with an unchanged federal funds rate of about 5½ percent and that retained a bias toward the possible firming of reserve conditions and a higher federal funds rate during the intermeeting period. Accordingly, in the context of the Committee's long-run objectives for price stability and sustainable economic growth, and giving careful consideration to economic, financial, and monetary developments, the Committee decided that a somewhat higher federal funds rate would be acceptable or a slightly lower federal funds rate might be acceptable during the intermeeting period. The reserve conditions contemplated at this meeting were expected to be consistent with moderate growth in M2 and M3 over coming months.

The Federal Reserve Bank of New York was authorized and directed, until instructed otherwise by the Committee, to execute transactions in the System Account in accordance with the following domestic policy directive:

The information reviewed at this meeting suggests that economic activity continued to grow rapidly in recent months. In labor markets, hiring has remained robust and the civilian unemployment rate fell to 4.7 percent in October, its low for the current economic expansion. Industrial production increased very rapidly in the third quarter, and appears to have remained strong in October. Retail sales also rose sharply in the third quarter, though at a moderating pace as the summer progressed. Housing starts, while fluctuating from month to month, were little changed on balance in the third quarter. Business fixed investment posted unusually strong increases in the latest quarter, and available indicators point to further sizable gains in coming months. The nominal deficit on U.S. trade in goods and services widened substantially on average in July and August from its rate in the second quarter. Price inflation has remained subdued despite some increase in the pace of advance in labor compensation.

Short-term interest rates have registered small mixed changes since the day before the Committee meeting on September 30, 1997, while bond yields have fallen somewhat. Share prices in U.S. equity markets have fluctuated widely in turbulent trading activity and are down on balance over the period; equity markets in other countries, notably in Asia, have been volatile as well and some have registered very large declines. In foreign exchange markets, the trade-weighted value of the dollar in terms of the other G-10 currencies declined somewhat on balance over the intermeeting period. The dollar appreciated significantly, however, in terms of the currencies of a number of Asian and Latin American countries.

Growth of M2 and M3 appears to have moderated further in October from the unusually brisk rates of August. For the year through October, M2 expanded at the upper bound of its range for the year and M3 at a rate substantially above the upper bound of its range. Total domestic nonfinancial debt has expanded in recent months at a pace somewhat below the middle of its range.

The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. In furtherance of these objectives, the Committee at its meeting in July reaffirmed the ranges it had established in February for growth of M2 and M3 of 1 to 5 percent and 2 to 6 percent respectively, measured from the fourth quarter of 1996 to the fourth quarter of 1997. The range for growth of total domestic nonfinancial debt was maintained at 3 to 7 percent for the year. For 1998, the Committee agreed on a tentative basis to set the same ranges as in 1997 for growth of the monetary aggregates and debt, measured from the fourth quarter of 1997 to the fourth quarter of 1998. The behavior of the monetary aggregates will continue to be evaluated in the light of progress toward price level stability, movements in their velocities, and developments in the economy and financial markets.

In the implementation of policy for the immediate future, the Committee seeks conditions in reserve markets consistent with maintaining the federal funds rate at an average of around 5½ percent. In the context of the Committee's long-run objectives for price stability and sustainable economic growth, and giving careful consideration to economic, financial, and monetary developments, a somewhat higher federal funds rate would or a slightly lower federal funds rate might be acceptable in the intermeeting period. The contemplated reserve conditions are expected to be consistent with moderate growth in M2 and M3 over coming months.

Votes for this action: Messrs. Greenspan, McDonough, Ferguson, Gramlich, Guynn, Kelley, Meyer, Moskow, Parry, Mses. Phillips and Rivlin. Vote against this action: Mr. Broaddus.

Mr. Broaddus dissented because he believed that a modest tightening of policy would be prudent in view of the recent strength in aggregate demand for goods and services; such demand appeared to be growing considerably more rapidly than the sustainable rate at which it could be supplied without an increase in inflation. While he recognized that a tightening at this meeting presented risks in view of recent financial and economic developments in East Asia, he believed these risks were outweighed by the risk that policy would have to be tightened more aggressively if action were delayed, demand remained robust, and the recent apparent reduction in inflationary expectations were reversed. The negative impact on economic activity in such circumstances would be markedly greater than if a more modest action were taken at this meeting.

Rules Regarding Availability of Information

By notation vote the Committee unanimously approved in final form certain revisions to its Rules Regarding the Availability of Information. The final rules take account of comments received from the public on the Committee's proposed revisions to the rules that were published earlier in the Federal Register. The purpose of the revisions is to bring the rules into conformity with the Electronic Freedom of Information Act of 1996, which amends the Freedom of Information Act. The new rules take effect on December 17, 1997.

It was agreed that the next meeting of the Committee would be held on Tuesday, December 16, 1997.

The meeting adjourned at 1:10 p.m.

Donald L. Kohn
Secretary

Meeting Held on December 16, 1997

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Wednesday, December 16, 1997, at 9:00 a.m.

Present:

Mr. Greenspan, Chairman
Mr. McDonough, Vice Chairman
Mr. Broaddus
Mr. Ferguson
Mr. Gramlich
Mr. Guynn
Mr. Kelley
Mr. Moskow
Mr. Meyer
Mr. Parry
Ms. Phillips
Ms. Rivlin

Messrs. Hoenig, Jordan, and Ms. Minehan, Alternate Members of the Federal Open Market Committee

Messrs. Boehne, McTeer, and Stern, Presidents of the Federal Reserve Banks of Philadelphia, Dallas, and Minneapolis respectively

Mr. Kohn, Secretary and Economist
Mr. Bernard, Deputy Secretary
Mr. Coyne, Assistant Secretary
Mr. Gillum, Assistant Secretary
Mr. Mattingly, General Counsel
Mr. Baxter, Deputy General Counsel
Mr. Prell, Economist
Mr. Truman, Economist

Messrs. Beebe, Cecchetti, Eisenbeis, Goodfriend, Lindsey, Promisel, Siegman, Slifman, and Stockton, Associate Economists

Mr. Fisher, Manager, System Open Market Account

Mr. Winn, Assistant to the Board, Office of Board Members, Board of Governors

Mr. Ettin, Deputy Director, Division of Research and Statistics, Board of Governors

Messrs. Madigan and Simpson, Associate Directors, Divisions of Monetary Affairs and Research and Statistics respectively, Board of Governors

Messrs. Alexander, Hooper, and Ms. Johnson, Associate Directors, Division of International Finance, Board of Governors

Ms. Low, Open Market Secretariat Assistant, Division of Monetary Affairs, Board of Governors

Messrs. Connolly and Rives, First Vice Presidents, Federal Reserve Banks of Boston and St. Louis respectively

Mses. Browne, Krieger,
Messrs. Dewald, Hakkio, Lang, and Rosenblum, Senior Vice Presidents, Federal Reserve Banks of Boston, New York, St. Louis, Kansas City, Philadelphia, and Dallas respectively

Mr. Miller, Vice President, Federal Reserve Bank of Minneapolis

Messrs. Bryan and Evans, Assistant Vice Presidents, Federal Reserve Banks of Cleveland and Chicago respectively

By unanimous vote, the minutes of the meeting of the Federal Open Market Committee held on November 12, 1997, were approved.

The Manager of the System Open Market Account reported on developments in foreign exchange and international financial markets in the period since the previous meeting on November 12, 1997. There were no open market transactions in foreign currencies for System Account during this period, and thus no vote was required of the Committee.

The Manager also reported on developments in domestic financial markets and on System open market transactions in government securities and federal agency obligations during the period November 12, 1997, through December 15, 1997. By unanimous vote, the Committee ratified these transactions.

The Committee then turned to a discussion of the economic outlook and the conduct of monetary policy over the intermeeting period ahead.

The information reviewed at this meeting suggested that economic activity had continued to grow at a rapid pace in recent months. The further advance reflected moderating but still sizable increases in business fixed investment and consumer spending and an upturn in business inventory accumulation. Housing demand remained at a high level, and deepening trade deficits provided only a partial offset to the strength in domestic spending. Against this background, employment and production posted further large gains. Price inflation remained subdued despite tight labor markets and some pickup in the rate of wage increases.

Nonfarm payroll employment rose sharply further in October and November. The increases in payrolls were widespread across sectors, and in November they included notably large gains in the service-producing industries. Manufacturing employment also rose considerably further in November, and aggregate weekly hours of production or nonsupervisory workers registered a particularly large advance in that month. The civilian unemployment rate fell to 4.6 percent in November, its low for the current expansion.

Industrial production continued to advance at a brisk pace in October and November. The November increase was widespread across market groups. It featured particularly strong growth in the production of durable goods, including a surge in the output of motor vehicles and parts. Partly offsetting the strength in the manufacturing sector in November was a decline in mining activity and in utilities output after two months of robust expansion. The large rise in production boosted the rate of utilization of manufacturing capacity to its highest level in more than two years.

Growth in consumer spending had moderated in recent months from a very brisk pace during the summer. Retail sales were unchanged on balance over October and November after having increased rapidly in the third quarter. The flat sales for the two months reflected some softening in the durable goods category, notably at automotive dealers, and relatively slow growth in the nondurable goods sector. Consumer spending on services appeared to have remained relatively robust in October. According to recent surveys, consumer sentiment continued at an extraordinarily ebullient level in the context of further strong gains in jobs and incomes, the cumulative effect of large increases in household net worth, and the ready availability of financing for most consumers.

Available information suggested that business capital expenditures had moderated in recent months from the exceptionally strong increases of the second and third quarters. Shipments of office and computing equipment fell in nominal terms in October, while shipments of communications equipment were about unchanged after having posted strong gains earlier in the year. Shipments of nondefense capital goods other than aircraft and high tech equipment also declined in October. Spending on nonresidential structures had softened a bit in recent months.

In the housing sector, demand had continued to display appreciable strength in recent months in association with relatively moderate mortgage rates and very positive consumer assessments of homebuying conditions. In October, the latest month for which data were available, sales of new homes were well maintained, and sales of existing homes rose. Housing starts increased somewhat in October and November from the already high level reached earlier in the year.

After having picked up considerably in September, the pace of business inventory investment in October remained above that recorded earlier in the summer. The rise in stocks at the manufacturing level was at a somewhat faster pace in October than in September, but the buildup in inventories at the wholesale level, and especially at the retail level, moderated in October. On balance, inventories remained at quite low levels in relation to shipments and sales.

The nominal deficit on U.S. trade in goods and services was significantly larger in the third quarter than in the second. Exports of goods and services rose only marginally in the third quarter, as increases in machinery, industrial supplies, and service receipts were nearly offset by sharp declines in exports of aircraft and gold. Imports of goods and services rose appreciably in the third quarter; the increases were in most major trade categories and included strong further advances in the quantity of oil imports. Economic growth in most major foreign industrial countries was relatively vigorous in the third quarter, and preliminary indicators for the fourth quarter suggested continued above-trend expansion. However, growth since midyear appeared to have recovered only modestly in Japan from a sharp second-quarter decline. The ongoing financial turmoil affecting a number of Asian economies had led to a significant slowdown in economic activity in the region. Available data also suggested a favorable economic performance in major Latin American countries in the third quarter.

Consumer price inflation had remained at a low level in recent months, reflecting a variety of influences including a favorable labor cost environment, falling import prices, small increases in energy prices, and declining inflation expectations. For the twelve months ended in November, overall consumer prices and consumer prices excluding food and energy items increased appreciably less than in the year-earlier period. At the producer level, prices for finished goods edged lower in November and the index was down somewhat on balance over the past year, reflecting declines in the food and energy components. The rate of increase in average hourly earnings had picked up in recent months, apparently reflecting the effects of an increase in the federal minimum wage and some bidding up of wages in a tight labor market.

At its meeting on November 12, 1997, the Committee adopted a directive that called for maintaining conditions in reserve markets that were consistent with an unchanged federal funds rate averaging around 5½ percent. In the directive the Committee retained a tilt toward a possible firming of reserve conditions during the intermeeting period. Such a bias was seen as consistent with the members' views that the risks continued to be skewed toward rising inflation and that the next policy move was more likely to be in the direction of some firming than toward easing. Reserve market conditions associated with this directive were expected to be consistent with some moderation in the growth of M2 and M3 over coming months.

Open market operations throughout the intermeeting period were directed toward maintaining reserve conditions consistent with the intended average of around 5½ percent for the federal funds rate, and the average effective rate over the period was close to that rate level. In other domestic financial markets, short-term interest rates registered small mixed changes since the day before the Committee meeting on November 12, 1997, while bond yields fell somewhat. Share prices in U.S. equity markets recorded mixed changes over the period. Domestic financial markets became somewhat less volatile over the period, though further turmoil in a number of foreign markets fostered a sense of unease that was reflected in relatively wide yield spreads and, on occasion, in trading activity and price movements. Equity markets in other countries, notably in Asia, remained volatile.

In foreign exchange markets, the value of the dollar rose over the intermeeting period in terms of both the trade-weighted index of the other G-10 currencies and the currencies of a number of Asian countries. The dollar's appreciation against the German mark and other Western European currencies appeared to reflect market perceptions that the prospects for monetary tightening had ebbed in those countries in light of the persistence of subdued inflation and indications that the continuing financial turmoil in Asian and other emerging economies was likely to have a retarding effect on the economies of the industrial countries. The dollar's appreciation relative to the yen appeared to reflect rising concerns about the Japanese economy in the wake of continuing financial difficulties in Japan and spillover effects from events elsewhere in Asia. The dollar strengthened further in this period against most of the other East Asian currencies, notably against the Korean won.

Growth in the broad monetary aggregates picked up to relatively rapid rates in November. Strength in currency and a surge in liquid deposits boosted the expansion of M2, while that of M3 was amplified by a step-up in RP borrowing to help finance more rapid growth in bank credit. For the year through November, M2 expanded at a rate that was slightly above the upper bound of the Committee's annual range and M3 at a rate substantially above the upper bound of its range. The increase in total domestic nonfinancial debt for the year to date was at a pace somewhat below the middle of the Committee's range.

The staff forecast prepared for this meeting suggested somewhat greater moderation in economic expansion than had been projected earlier and slightly less pressure on wages and prices. A number of factors were expected to contribute to the slowing of aggregate demand and reduced pressure on resources. These included: a slackening in world economic expansion that, in conjunction with the appreciation of the dollar, would substantially restrain U.S. exports; some moderation of the growth in household and business investment; and a diminution in the desired rate of inventory accumulation.

In the Committee's discussion of current and prospective economic developments, members commented on indications that growth in economic activity had remained solid and that inflation had continued to be surprisingly low. While wages appeared to be increasingly subject to upward pressure, productivity had picked up in recent quarters, and the persisting strength in profits suggested that unit labor costs were not accelerating noticeably. The evidently higher pace of productivity growth was very encouraging, though it was still difficult to assess how long this favorable performance might last and the extent to which it might ease the price pressures that could emerge if the economic expansion did not moderate as members anticipated. Domestic demand for goods and services had been quite strong and was likely to remain reasonably robust. However, the effects of the persisting turmoil in Asian financial markets were likely to moderate the pace of expansion, though the extent of this effect was difficult to judge. The ongoing turbulence since the last Committee meeting, which included further noticeable increases in the dollar against the currencies of affected countries, likely would have a somewhat greater damping effect on output and prices in the United States than previously had been anticipated. Exports to many Asian countries, and possibly to other U.S. trading partners whose economies might be adversely affected by the spillover effects of developments in Asia, would be reduced, and declines in import prices would ease inflation pressures. However, the ultimate extent of the adjustment in Asian economies remained unknown, and more substantial downward pressure on the economies of the United States and its trading partners could not be ruled out.

With regard to the prospects for final demand in key sectors, the members noted that the appreciation of the dollar against a wide range of currencies, along with the prospective slackening in world economic expansion associated with the Asian turmoil, could be expected to exert a considerable damping effect on U.S. exports over the next several quarters. In addition, increased uncertainty about financial asset values, possibly related in part to further difficulties in Asia, could lead to greater caution in spending, while a substantial decline in equity values, should it occur, would have a more pronounced effect by reducing household wealth and raising the cost of equity capital. However, a number of members suggested that consumer spending might hold up relatively well if the effects of the Asian crisis on the U.S. economy were not markedly deeper or more prolonged than currently expected. To date, anecdotal reports indicated only scattered signs of weaker export demand, primarily some slackening in orders for and shipments of selected commodities such as agricultural goods and lumber and wood products, and there were few indications of reduced demand for manufactured goods. At the same time, business contacts were optimistic about holiday sales, tourism was booming in some parts of the country, and spending for services had been brisk. In the circumstances, continuing gains in wages and employment, the prevailing high levels of confidence, the cumulative effects of very large increases in household wealth in recent years, and the intense competition among retailers for the consumer's attention could promote substantial further growth in consumer expenditures. The same factors, along with the favorable cash flow affordability of home ownership, were maintaining housing demand at a relatively high level.

The outlook for business fixed investment remained favorable. In the near term, the low cost of capital, the ready availability of finance on attractive terms, and the potential for reducing production costs in highly competitive markets were providing strong support for capital spending. Moreover, shrinking vacancy rates and rising lease rates were fostering a rapid increase in the number of large commercial building projects, notably office buildings, that were planned or under way in many areas of the country. Even so, the growth of business capital spending was expected to slow from the unusually rapid pace of recent quarters in response to the projected smaller increases in sales and profits arising from moderating economic growth. In addition, business firms were expected to trim the pace of their inventory accumulation to keep stocks at desired levels relative to sales.

In their comments on recent developments in labor markets, the members emphasized the very limited supply of new workers and the extraordinary tightness prevailing in markets throughout the nation. Several reported that the scarcity of available workers was limiting the growth of economic activity in some parts of the country and that some employers were trying out novel approaches aimed at enticing people not currently seeking a job to enter the work force. While wage increases remained moderate on balance, larger increases were gradually becoming more pervasive as labor markets tightened. Moreover, employers were continuing their efforts to attract or retain workers that were in particularly scarce supply by means of a variety of bonus payments and other incentives that were not included in standard measures of labor compensation. There also were reports of offers of expanded benefits and, in some instances, the granting of very large wage increases to highly skilled technical personnel.

In the course of their discussion, many members remarked on the absence of inflationary price pressures during a period when economic activity had risen briskly and labor markets had grown steadily tighter. The muted effect of higher labor compensation on unit labor costs and prices reflected sharp advances in productivity partly associated with the rapid expansion of the stock of capital; the latter had been stimulated, most probably, by the desire to enhance efficiency and thus hold down costs. In addition, the earlier appreciation of the dollar and the unusually damped increases in the cost of health benefits in recent years had helped to limit the rise in compensation.

As members had noted at previous meetings, these favorable influences were likely to erode over time. Anecdotal reports indicated that health insurance premiums were beginning to trend higher, and the dollar would not rise indefinitely. More fundamentally, persistent tightness in labor markets risked a continuing uptrend in labor compensation increases that, at some point, could not be fully offset by productivity gains. Under those circumstances, competitive market conditions would allow firms to raise prices to compensate for increases in their costs. However, for some period ahead, developments associated with the turmoil in Asia along with the partly related appreciation of the dollar would tend to intensify import competition and damp the prices of goods.

In the Committee's discussion of policy for the intermeeting period ahead, nearly all the members favored a proposal to maintain an unchanged policy stance. In their discussion, members emphasized that price inflation had remained subdued, indeed with some key price measures indicating declining inflation, despite the persistence of robust economic growth and high levels of resource use, notably in labor markets. They expressed concern, however, that multiplying indications of faster wage increases might presage rising price inflation at some point. Weighing against the risks of higher inflation was the financial turmoil that had intensified in Southeast Asia during October and more recently in Korea. The effects of those developments on the U.S. economy were quite limited thus far, but the members expected some damping of economic expansion and price increases in the quarters ahead, and they did not rule out a potentially strong impact in the event of an even deeper crisis in Asia, or one that spread to other countries. Nonetheless, many members commented that, with domestic demand still quite strong and the economy possibly producing beyond its potential, they viewed the risks on balance as pointing to rising price inflation and the next policy move as likely to be in the direction of some tightening. However, most members agreed that the need for such a policy adjustment did not appear to be imminent and that prevailing near-term uncertainties warranted a cautious wait-and-see policy posture. One member, while acknowledging the downside risks to the expansion associated with potential developments in Asia, still was persuaded that the economy probably would continue to expand at an unsustainable pace and that monetary policy should be tightened promptly to avert a further buildup of pressures in already strained labor markets, associated increases in labor costs, and at some point an inevitable rise in price inflation.

Other considerations cited by some members in favor of an unchanged policy included the possibility that, because a policy tightening move was not expected at this juncture, even a modest firming action might well have outsized effects in financial markets, especially the foreign exchange markets. Current conditions in domestic financial markets clearly remained supportive of spending, but it also was noted that the real federal funds rate was relatively high and that growth in the broad measures of money was expected to moderate over coming months after a period of robust expansion. The members agreed that the crosscurrents that were generating the present uncertainties in the outlook for economic activity and inflation made a flexible approach to monetary policy particularly desirable at this juncture.

Views were somewhat more divided with regard to the instruction in the directive relating to the possible adjustment of policy during the intermeeting period. A majority of the members indicated a preference for a shift to a symmetrical directive even though many continued to anticipate that the next policy move was likely to be in a tightening direction. They noted that while the probability of any policy change in the near term was very low, uncertainties in the outlook had increased, and they could not rule out the possibility that the next change might be in the direction of some easing if, contrary to current expectations, the turmoil in Asia were to intensify to the extent that it seemed likely to exert very substantial effects on the U.S. economy. A symmetric directive would position the Committee to respond flexibly in either direction to unanticipated developments in the period ahead. Other members expressed a slight preference for retaining a directive that was tilted toward tightening. In their view, such a directive would continue to underscore their concern that, at current and prospective levels of resource utilization, rising inflation was the most serious risk to the economy and that the Committee remained committed to fostering progress toward a stable price environment that in turn would heighten the prospects for sustained economic expansion and full employment.

At the conclusion of the Committee's discussion, all but one member endorsed a directive that called for maintaining conditions in reserve markets that were consistent with an unchanged federal funds rate of about 5½ percent and that did not include a presumption about the likely direction of any adjustment to policy during the intermeeting period. Accordingly, in the context of the Committee's long-run objectives for price stability and sustainable economic growth, and giving careful consideration to economic, financial, and monetary developments, the Committee decided that a slightly higher or a slightly lower federal funds rate might be acceptable during the intermeeting period. The reserve conditions contemplated at this meeting were expected to be consistent with some moderation in the growth of M2 and M3 over coming months.

The Federal Reserve Bank of New York was authorized and directed, until instructed otherwise by the Committee, to execute transactions in the System Account in accordance with the following domestic policy directive:

The information reviewed at this meeting suggests that economic activity continued to grow rapidly in recent months. Nonfarm payroll employment increased sharply in October and November; the civilian unemployment rate fell to 4.6 percent in November, its low for the current economic expansion. Industrial production continued to advance at a brisk pace in October and November. Retail sales were unchanged on balance over the two months after rising sharply in the third quarter. Housing starts increased slightly further in October and November. Available information suggests on balance that business fixed investment will slow from the exceptionally strong increases of the second and third quarters. The nominal deficit on U.S. trade in goods and services widened significantly in the third quarter from its rate in the second quarter. Price inflation has remained subdued, despite some increase in the pace of advance in wages.

Short-term interest rates have registered small mixed changes since the day before the Committee meeting on November 12, 1997, while bond yields have fallen somewhat. Share prices in U.S. equity markets recorded mixed changes over the period; equity markets in other countries, notably in Asia, have remained volatile. In foreign exchange markets, the value of the dollar has risen over the intermeeting period in terms of both the trade-weighted index of the other G-10 countries and the currencies of a number of Asian countries.

M2 and M3 grew rapidly in November. For the year through November, M2 expanded at a rate slightly above the upper bound of its range for the year and M3 at a rate substantially above the upper bound of its range. Total domestic nonfinancial debt has expanded in recent months at a pace somewhat below the middle of its range.

The Federal Open Market Committee seeks monetary and financial conditions that will foster price stability and promote sustainable growth in output. In furtherance of these objectives, the Committee at its meeting in July reaffirmed the ranges it had established in February for growth of M2 and M3 of 1 to 5 percent and 2 to 6 percent respectively, measured from the fourth quarter of 1996 to the fourth quarter of 1997. The range for growth of total domestic nonfinancial debt was maintained at 3 to 7 percent for the year. For 1998, the Committee agreed on a tentative basis to set the same ranges as in 1997 for growth of the monetary aggregates and debt, measured from the fourth quarter of 1997 to the fourth quarter of 1998. The behavior of the monetary aggregates will continue to be evaluated in the light of progress toward price level stability, movements in their velocities, and developments in the economy and financial markets.

In the implementation of policy for the immediate future, the Committee seeks conditions in reserve markets consistent with maintaining the federal funds rate at an average of around 5½ percent. In the context of the Committee's long-run objectives for price stability and sustainable economic growth, and giving careful consideration to economic, financial, and monetary developments, a slightly higher federal funds rate or a slightly lower federal funds rate might be acceptable in the intermeeting period. The contemplated reserve conditions are expected to be consistent with some moderation in the growth in M2 and M3 over coming months.

Votes for this action: Messrs. Greenspan, McDonough, Ferguson, Gramlich, Guynn, Kelley, Meyer, Moskow, Parry, Mses. Phillips and Rivlin. Vote against this action: Mr. Broaddus.

Mr. Broaddus dissented because he continued to believe that a modest tightening of policy would be prudent in light of the apparent persisting strength in aggregate demand for goods and services. He recognized the case for holding policy steady given recent developments in East Asian economies and financial markets; he believed, however, that a slight firming at this meeting would provide valuable insurance against the risk that demand growth might remain above a sustainable trend and require a sharper policy response later. He thought further that the potential benefits of this insurance outweighed the risk that such an action would have a significant negative impact on U.S. economic activity. He also believed that signaling a greater willingness to tolerate modest policy adjustments in response to emerging developments would foster more flexible movements in longer-term financial markets and specifically enable longer-term interest rates to play their traditional role as automatic stabilizers for the economy more effectively.

It was agreed that the next meeting of the Committee would be held on Tuesday–Wednesday, February 3–4, 1998.

The meeting adjourned at 12:45 p.m.

Donald L. Kohn
Secretary